



Outlook 2020 Fragile – handle with care

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In 2019 we've dealt with questions about the German economy, about German politics – fiscal policy and the black zero, in particular – and, more fundamentally, about Germany's future given the risk of a more permanent reversal of globalisation, the increased environmental focus, the challenges for the German car industry and the widespread notion that Germany might miss the boat on the big data economy and other technological trends. These negative narratives go a long way toward explaining why German corporates' investment spending has been so lackluster and why more than two-thirds of voters are dissatisfied with the government. That the same percentage prefers a Groko continuation is probably an indication of a broad-based lack of orientation.

There are no straightforward answers to these structural questions. History is likely of little help as some challenges are completely new. However, the country has gone through similar periods of foreign observers painting Germany's future in dark hues ("The sick man of Europe") with notoriously skeptical Germans joining in. This might explain our cautiously optimistic stance on these issues in this economic outlook.

Similarly, regarding the cyclical outlook for 2020, a dose of optimism doesn't hurt. Even with a clear Conservative victory, Brexit uncertainty has hardly disappeared. Chances of an encompassing trade deal before end-2020 appear close to nil, especially given the wide-apart positions. The US-China Phase I deal seems to indicate a temporary truce, but probably doesn't go far enough to squash the rise in trade policy uncertainty, and it is far from clear what it might imply for lingering US-EU trade disputes.

Assuming no setbacks on either front, we anticipate a gradual recovery in global trade in 2020, which should enable a piecemeal recovery in exports and help end the industrial recession. Still, we expect equipment spending to decline in 2020, as sentiment will rebound only gradually. The domestic growth pillars – private and government consumption as well as construction – should continue to expand at a healthy clip, given expansionary fiscal policy and, most importantly, our expectation that the German labour market will hold up despite the industrial recession. But annual GDP growth of 1% forecast for 2020 after 0.5% in 2019 is clearly underwhelming, especially since the acceleration versus 2019 is almost exclusively the result of an unusually high number of working days in 2020.



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Economic forecasts

	Real GDP (% growth)			Consumer Prices* (% growth)			Current Account (% of GDP)			Fiscal Balance (% of GDP)		
	2019	2020F	2021F	2019	2020F	2021F	2019	2020F	2021F	2019	2020F	2021F
Euroland	1.2	1.0	1.2	1.2	1.1	1.2	2.5	2.1	1.8	-0.9	-1.1	-1.2
Germany	0.5	1.0	1.1	1.4	1.0	1.4	7.2	6.7	6.1	1.2	0.5	0.0
France	1.3	1.2	1.2	1.3	1.3	1.2	-0.3	-0.2	-0.2	-3.2	-2.4	-2.3
Italy	0.2	0.5	0.6	0.7	0.7	1.0	3.1	2.7	2.7	-2.2	-2.4	-2.3
Spain	2.0	1.6	1.6	0.8	1.0	1.4	0.6	0.4	0.3	-2.1	-2.4	-2.2
Netherlands	1.7	1.6	1.6	2.7	1.8	1.7	10.0	9.8	9.6	0.7	0.2	0.0
Belgium	1.3	1.1	1.3	1.3	1.3	1.6	-1.0	-1.0	-1.0	-1.5	-2.0	-2.0
Austria	1.5	1.4	1.4	1.5	1.6	1.6	2.0	1.8	1.8	0.4	0.2	0.3
Finland	1.6	1.2	1.3	1.2	1.1	1.1	-1.5	-1.5	-1.0	-0.9	-1.1	-1.1
Greece	1.4	1.7	2.0	0.4	0.3	1.7	-2.5	-2.0	-1.5	1.2	0.5	0.4
Portugal	1.9	1.5	1.6	0.3	0.5	1.0	-0.2	-0.5	-0.7	-0.3	-0.2	0.2
Ireland	5.4	3.0	3.5	0.9	0.9	0.8	3.0	4.0	5.0	0.4	0.0	0.2
UK	1.2	1.0	1.4	1.8	1.4	1.7	-5.3	-4.7	-4.3	-2.3	-2.8	-2.6
Denmark	1.9	1.5	1.5	0.9	1.2	1.3	7.0	6.9	6.9	2.0	0.5	0.0
Norway	2.5	1.9	1.8	2.3	1.9	2.0	6.8	6.0	6.4	7.5	7.3	7.3
Sweden	1.1	1.1	1.5	1.7	1.6	1.7	3.7	4.0	4.4	0.4	0.1	0.2
Switzerland	0.9	1.9	1.5	0.5	0.5	0.9	10.1	10.2	10.3	1.1	1.1	0.9
Czech Republic	2.5	2.3	2.7	2.8	2.5	2.3	0.9	0.7	0.9	0.8	0.4	0.3
Hungary	5.0	3.5	3.5	3.3	3.3	3.4	-1.0	-0.8	-0.6	-1.7	-1.2	-1.0
Poland	4.2	3.8	3.6	2.3	2.7	2.8	-0.3	-0.7	-0.6	-1.0	-0.8	-1.1
United States	2.3	1.9	2.1	1.8	2.0	2.0	-3.0	-3.5	-3.5	-4.5	-4.5	-4.5
Japan	1.0	0.1	1.1	0.5	0.5	0.7	3.5	3.9	4.3	-2.6	-2.7	-2.6
China	6.2	6.1	6.0	2.9	3.6	2.0	1.5	1.1	0.9	-4.9	-4.9	-4.4
World	3.1	3.3	3.5	3.1	3.1	2.8						

*Consumer price data for European countries based on harmonized price indices except for Germany. This can lead to discrepancies compared to other DB publications.
Sources: National Authorities, Deutsche Bank

Forecasts: German GDP growth by components, % qoq, annual data % yoy

	2018				2019				2020				2021			
	2018	2019	2020F	2021F	2018	2019	2020F	2021F	Q1	Q2	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Real GDP	1.5	0.5	1.0	1.1	0.1	0.3	0.3	0.3	0.1	0.2	0.3	0.3	0.1	0.2	0.3	0.3
Private consumption	1.3	1.5	1.2	1.0	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Gov't expenditure	1.4	2.0	1.5	1.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Fixed investment	3.5	2.7	1.9	2.1	0.4	0.4	0.6	0.6	0.3	0.4	0.5	0.5	0.3	0.4	0.5	0.5
Investment in M&E	4.4	0.7	-0.5	1.8	-0.2	0.1	0.5	0.5	0.0	0.3	0.4	0.5	0.0	0.3	0.4	0.5
Construction	2.5	4.1	3.7	2.7	0.8	0.7	0.7	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Inventories, pp	0.3	-0.4	-0.3	-0.4	0.0	0.1	0.0	0.0	-0.1	0.0	0.0	0.0	-0.1	0.0	0.0	0.0
Exports	2.1	1.0	2.3	2.1	0.3	0.5	0.7	0.7	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Imports	3.6	2.3	2.9	2.6	0.7	0.7	0.7	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Net exports, pp	-0.4	-0.5	-0.1	-0.1	-0.2	-0.1	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Consumer prices*	1.7	1.4	1.0	1.4												
Unemployment rate, %	5.2	5.0	5.1	5.2												
Industrial production**	1.1	-4.0	-1.5	1.0												
Budget balance, % GDP	1.9	1.2	0.5	0.0												
Public debt, % GDP	61.9	59.1	56.9	55.3												
Balance on current account, % GDP	7.3	7.2	6.7	6.1												
Balance on current account, EUR bn	241.4	246	236	220												

*Inflation data for Germany based on national definition. This can lead to discrepancies to other DB publications. **Manufacturing (NACE C)
Sources: Federal Statistical Office, Deutsche Bundesbank, Federal Employment Agency, Deutsche Bank Research



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Economic growth

1

Real GDP, % yoy	2017	2018	2019F	2020F
US	2.4	2.9	2.3	1.9
Japan	2.2	0.3	1.0	0.1
Euroland	2.7	1.9	1.2	1.0
Germany	2.5	1.5	0.5	1.0
France	2.4	1.7	1.3	1.2
Italy	1.8	0.7	0.2	0.5
Spain	2.9	2.4	2.0	1.6
Netherlands	2.9	2.6	1.7	1.6
Greece	1.4	1.9	1.4	1.7
Portugal	3.5	2.4	1.9	1.5
Ireland	8.2	8.3	5.4	3.0
UK	1.9	1.4	1.2	1.0
Asia (ex Japan)	6.2	6.2	5.3	5.5
China	6.8	6.6	6.2	6.1
India	6.9	7.4	5.1	6.1
Eastern Europe	2.7	2.9	2.0	2.9
Latin America	1.0	0.9	1.4	2.4
World	3.9	3.8	3.1	3.3

Sources: IMF, Deutsche Bank Research

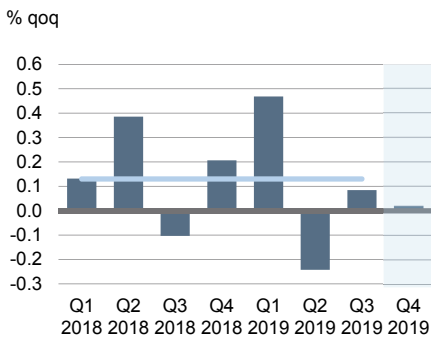
In 2019, the German economy has avoided a technical recession by a hair's breadth, but on average quarterly GDP basically flatlined throughout the year, despite the 0.5% jump in Q1 GDP, which was in part driven by catch-up effects. The massive slowdown was brought about by the economy's external side. Although foreign orders seem to have bottomed, they are still down about 9% compared to their peak in Q4 2018. Since mid-2018, real exports have on average increased a meagre 0.1% qoq, and net trade has subtracted an average 0.2 pp of GDP per quarter.

Without the world trade crunch Germany likely would have grown 1.75% in 2019

Despite global GDP expanding by about 3%, world trade (goods) will have dropped by about 0.5% in 2019, with the US-Chinese trade conflict, Brexit and the weakness of (trade-intensive) global capex spending being the key reasons. Moreover, these disputes have lowered global GDP growth by almost 1% in 2019, according to Fed simulations. Although neither factor is independent and both are derived from partial analysis, one can probably argue that with global GDP growth at around 4% and more normal trade elasticity of 1, German exports would have grown by an additional 4 pp; subtracting higher import demand, this – ceteris paribus – would have resulted in GDP growth of 1.25 pp higher than the 0.5% expected for 2019. While this is clearly a very rough estimate, it provides an indication of the welfare loss.

German GDP profile

2



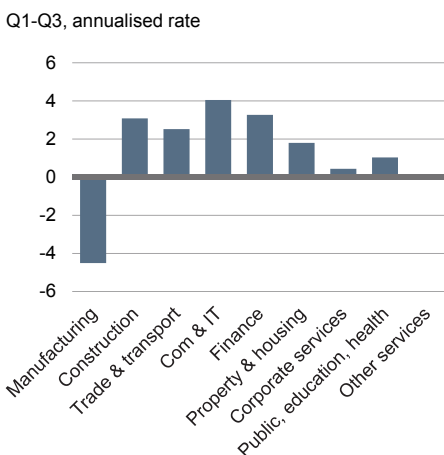
Source: Federal Statistical Office

External headwinds are expected to ease

This counterfactual scenario highlights the importance of the assumptions for global growth in our 2020 forecast, particularly regarding developments in the US/Chinese trade conflict and a still-possible US tariff increase on car imports. The Phase 1 deal confirmed by the US and China is more or less in line with market expectations: the tariffs scheduled for mid-December have been suspended, although the rollback – US tariffs on USD 120bn of Chinese imports have been cut from 15% to 7.5% – was at the lower end of expectations. China has committed to larger agricultural purchases. But details on these purchases or other subjects – for example, the protection of property rights, technology transfer or dispute resolution and measures on technology transfer – remain vague. Furthermore, there is still no clarity with respect to US-EU trade issues, although we do not assume that the US will impose higher tariffs on car imports.

Gross value added by sector

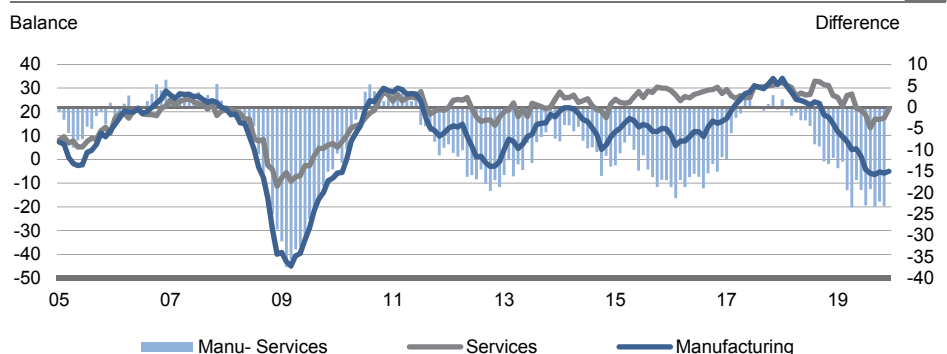
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Sources: Federal Statistical Office, Deutsche Bank

ifo: Services / manufacturing gap

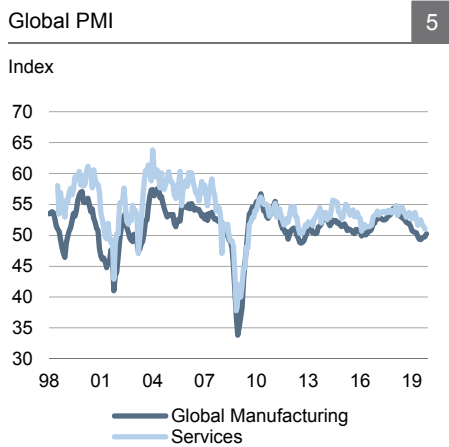
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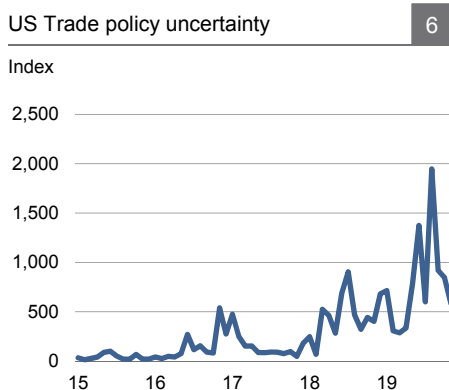
Sources: ifo, Deutsche Bank Research



Modest upward revisions for key countries



Sources: Haver Analytics LP, Deutsche Bank Research



Sources: PolicyUncertainty.com, Haver Analytics LP



Sources: CPB, Federal Statistical Office

This more optimistic view – likely shared by the majority of market participants – has already resulted in a clear reversal of global economic policy uncertainty. This index declined to 265.8 in November from its peak of 336 in August. Since early October, when the US administration’s tonality regarding trade negotiations started to improve, the MSCI world index has gained about 10%. In November the global manufacturing PMI (50.3) climbed above 50 for the first time since April. The Taiwanese manufacturing PMI, which tends to lead the global index by about two months, even jumped to 54.9 – a 6.9-point rise from the July trough. That said, the flash PMIs for December again provided less optimistic reading. The Bundesbank’s leading indicator for global IP started to inch higher in October/November. Our colleagues have upgraded their forecasts for both the US and the Chinese economies. In the US, sentiment indicators have rebounded somewhat, the labour market has offered substantial upside surprises, and model-implied recession probabilities have clearly fallen. Our colleagues now see the US economy bottoming in Q4 2019, half a year earlier than previously thought, and have lifted their 2020 GDP forecast from 1.5% to 1.7%. In a similar vein, our colleagues in Asia have raised their China forecast, expecting growth might have bottomed in Q3 already or do so by Q1 2020 at the latest. Of course this forecast also rests largely on our trade policy assumption, but is also supported by fiscal expansion and monetary easing. The annual GDP growth forecast for China has inched up to 6.1% compared to 5.9% in November.

Financial markets to remain supportive

We do not expect any change in policy rates on either side of the Atlantic in 2020. Our strategists believe US 10y yields could drift slightly lower over the summer but end 2020 at around 1.9%, near their current level. With European growth concerns receding somewhat during 2020 and Germany moving towards a fiscal deficit in 2021, 10y bund yields could drift towards 0% by end-2020. Given the decline in economic policy uncertainty and the expected stabilisation in US and global growth during 2020, our strategists call for the S&P 500 to rise modestly in 2020 (year-end target 3250). In such a scenario, they see opportunity for European stocks to do somewhat better given their higher beta and lower valuations (relative to the US).

The risk in our key assumption

However, the improvement has thus far taken place mainly in sentiment data and still doesn’t present an unambiguous signal. Hard monthly data has provided even more of a mixed bag. And – nota bene – until now the improvement in financial markets and survey data such as ISM, ifo or PMIs has been driven primarily by hopes that the easing in US/Chinese trade tensions is real. The logic behind such a change in stance is intuitive: Both economies have started to feel the squeeze from tariff increases hitting exports and domestic investment spending. In an election year, President Trump should have no interest in taking risks with the economy. But we economists should not forget that forecasting politics based on economic cost-benefit analysis has its limits, especially when time inconsistency issues play a role, such as the assessment that the underlying conflict between the US and China can hardly be solved by a trade deal and could well become more acute in the coming years.



Another negative GDP print for Q4 is possible

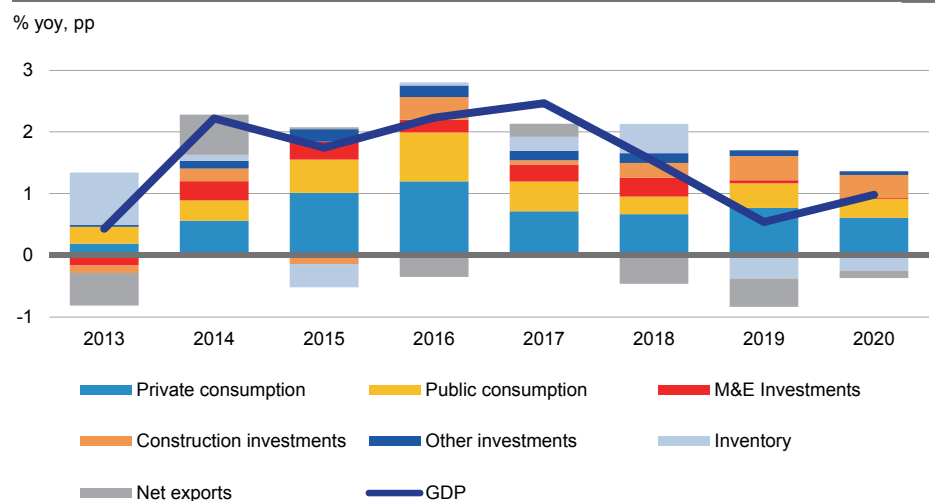
But even if our optimism proves right, global economy momentum might remain shallow throughout 2020. In many countries hard data has not yet deteriorated to the extent implied by sentiment data. This is particularly salient for Germany, where bridge models based on ifo and PMIs had predicted negative growth for Q3 of about ½%, while the economy eked out a 0.1% gain. This desynchronizing could imply that the impact is still to come, weighing down the economy in the winter half, or – similarly discouraging – that the budding improvement in sentiment data is just a correction of the recent overshooting but might not be mirrored in hard data. Either way, it does not bode well for Q4 GDP and probably the whole winter half year, for which we expect little more than stagnation. Given its poor start – with industrial production (-1.7%), orders (-0.4%) and retail sales (-1.6%) all down from September – Q4 could easily see another small drop in quarterly GDP.

German economy rests on a strong domestic pillar

Given the structurally tight labour market (p. 12), income growth should remain solid in 2020, supported by fiscal policy. Ongoing fiscal expansion should also drive public consumption and investment (p. 11 and 14). The property market boom seems to be taking off; the double-digit increase in housing-related credit growth will boost construction investment, which will still be held back by various bottlenecks (p. 22). The German economy's ongoing dichotomy shows up in the ifo Index gap between the manufacturing and service industries, which is still very wide – only exceeded in the 2009 crisis. In the first three quarters of 2019, all major sectors in the service industry posted positive growth – but for those closely related to the manufacturing sector, such as transport or corporate services, output has been falling (qoq) since Q2.

2013-2020 Germany: GDP growth contributions

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Sources: Deutsche Bank Research, Federal Statistical Office

Given the at best lackluster improvement in external demand (p. 7), we expect the contraction in corporate investment to continue into 2020. Even if uncertainty related to trade recedes further, the unclear path and impact of German and European environmental policy will likely dampen the business sector's inclination to invest (in Germany).

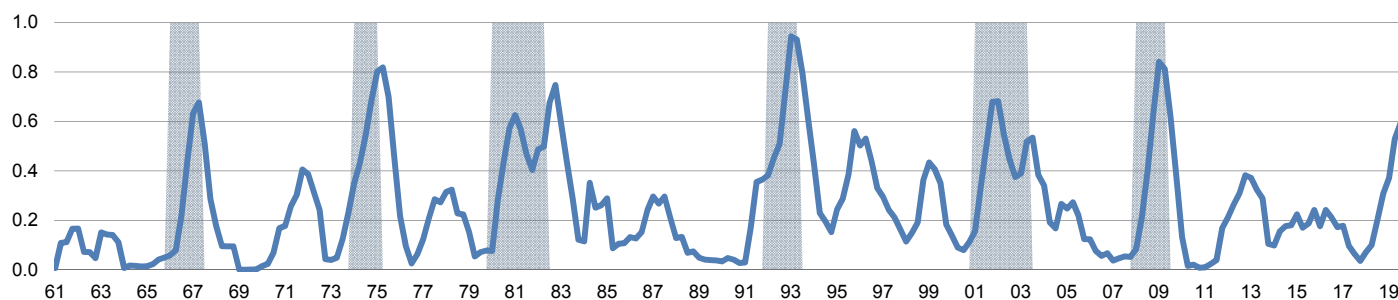


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All in all, we expect German GDP to increase by around 1% in 2020 after 0.5% in 2019. The positive output gap of recent years should be more or less eliminated by 2020, suggesting even lower upward pressure on core inflation. As energy prices are forecast to decline in 2020, headline inflation should move back toward 1% (p. 28).

Risk of recession* on decline in Q3 but not off the table

9



*to estimate recession probabilities we utilise a probit model. Dependent variable is a binary indicator that takes value of 1 for a negative qoq GDP growth. Shaded areas are the recession estimates by Council of Economic Experts. As controls we include new orders, ifo business climate index, industrial production (excluding construction) as well as corporate bond yields. Presented values are four quarter moving averages of recession probabilities.

Sources: ifo, Federal Statistical Office, Deutsche Bank Research

Recession risk not yet gone

Given that 2020 GDP growth will get a 0.4 pp boost from an unusually high number of working days, it seems clear that the economy will remain quite fragile, especially considering the structural challenges for the car industry and its suppliers or the uncertainty stemming from the increasing gap between the demands and political promises to slow climate change and the thus-far limited amount/impact of concrete measures, which raise concerns about the likelihood of harsher measures with even more disruptive effects on economic activity. A renewed escalation in the US/Chinese trade conflict, higher US auto tariffs on European cars or roadblocks in negotiating a post-Brexit trade agreement could be enough to push the German economy (finally) into recession territory.

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Stronger export growth thanks to US-China deal?!

Global trade vs. global PMI and US-Purchasing Managers Index: ISM 10



Sources: IHS Markit, ISM, CPB, Deutsche Bank Research

2018: 2020: Global GDP growth 11



Sources: Deutsche Bank Research, IMF

Led by restrictive US trade policy, global trade for goods and services lost more steam in 2019 and looks set to have expanded by less than 1%. For goods, the number was negative. The gradual escalation of the trade conflict between the US and China dampened global demand, but the US also raised tariffs on individual products from Europe and vice versa. The latent risk of US import tariffs on cars weighed on sentiment throughout the year, pushing export orders in the Purchasing Managers' Index for manufacturing to the lowest level since the financial crisis. But the extraordinarily pessimistic mood was only partly reflected in real exports, which look set to have edged up by around 1%. If – as expected in our base scenario – the trade conflict between the US and China de-escalates over the next year, global trade and, as a result, German exports ought to regain some momentum. In this environment, global trade of goods should pick up by 2½%, with German exports (goods and services) up c. 2%. If our assumption is correct, export growth – globally and in Germany – would again be below average. Like in the preceding years, growth of global exports including services should come in around one percentage point higher, at roughly 3½%.

Impact of export prices and exchange rates likely to be limited

Thanks to relatively stable commodity inflation, export prices in 2019 inched up by just ½%. In our view, the majority of commodity prices will likely be trading sideways for most of the year in 2020, too. The only exception is crude oil prices (Brent and WTI). Here, we forecast a sharp drop of more than 10%. Based on our calculations, export prices should actually shrink marginally in 2020, which would limit annual nominal export growth to only c. 1¾%. Our export forecasts are based on a sideways trend in real and nominal exchange rates. Assuming our export elasticity estimate of -2/3, a euro appreciation from the current EUR/USD 1.10 to 1.20 (annual averages) would slow German export growth by around 6 percentage points. However, as a rise in the euro is generally accompanied by a global rebound, our starting forecast would also have to be revised to the upside.

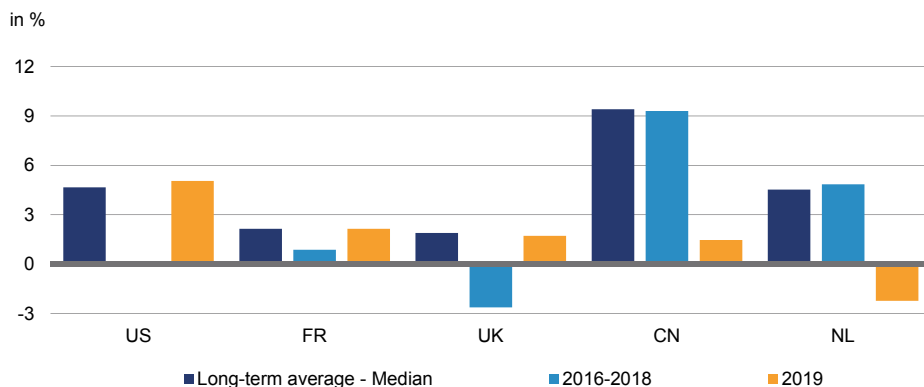
De-escalation of the trade conflict might trigger catch-up effects

In 2019, like in the preceding years, Germany's five largest export partners in nominal terms were the US, France, China, the Netherlands and the UK. Together, these countries absorb 37% of aggregate German exports. The core areas of the trade conflicts were clearly reflected in regional export growth. At 5%, growth of nominal exports to the US was slightly above average, partly due to the appreciation of the US dollar during the year. Exports to China, on the other hand, were up only 1.5%, following double-digit expansion in the previous years. If – as assumed – we enter a de-escalation phase in 2020, exports to China could benefit from marked catch-up effects, the more so as the Silk Road projects and the "Made in China 2025" strategy already argue for higher sales. As a consequence, average export growth rates of c. 5% to the US may well be exceeded. Without de-escalation, however, sales to China, in particular, would be weak and might even shrink. In this scenario, the question could be raised as to whether the loss of dynamics is structural, as in many sectors a rising share of Chinese demand for German products is produced locally.



Top 5 countries: Bilateral exports

12



Sources: Deutsche Bank Research, Federal Statistical Office

Tariffs on cars are like the sword of Damocles in the EU-US trade dispute, ...

From a German perspective, there are two key issues in the trade dispute between the EU and the US: the illegal subsidies to aircraft producers and – more importantly – the looming introduction of car tariffs. In 2019, cars and auto parts to the tune of nearly EUR 30 bn were exported to the US. If the US were to follow through on its threat to impose 25% tariffs, exports could decline by up to EUR 5 bn. But thanks to the relatively low price elasticity of luxury car demand, the negative effects of tariffs should be mitigated.

European aircraft sales volumes to the US are much lower. In October 2019, the WTO ruled that subsidies to Airbus are illegal, and it might, if able to act, issue a similar ruling on Boeing in the spring of 2020. However, with the US blocking the appointment of judges to the Appellate Body, the WTO's major settlement system for disputes between countries, negotiations between the EU and the US could be restricted to the bilateral level, with an uncertain outcome. After all, the US and the EU have been quarrelling over subsidies to the civil aviation industry for many years

... and an escalation could have sweeping geopolitical effects

A tariff shock, particularly for the automotive industry, might also have major effects on other sectors. To avoid the tariffs, German industry could push ahead with the establishment and expansion of US production facilities. In this case, France could overtake the US as Germany's key export market in a few years – recovering its position of former years. Production and consumption would then be more firmly anchored to the continent, and interest in a joint regulatory economic area, as envisaged in the failed TTIP negotiations of a few years ago, would increasingly fade. In the long term, transatlantic relations could continue to erode. Recently, the EU not only announced its determination to promote a stronger international role of the euro, particularly with respect to commodity trade, but also is considering the establishment of EU payment systems independent of the US. Against this backdrop, the play of thoughts on the future of NATO does not come as a surprise. The negative effects of these potentially "tectonic" shifts are obvious.



Euro area: Goods exports to Italy losing in importance

In 2019, exports to France and the Netherlands were up by around 2% each. For France, this marks a recovery relative to previous years, whereas exports to the Netherlands rose at a below-average rate. Owing to the Rhine – Germany's major inland waterway, which flows into the North Sea at the Port of Rotterdam – the Netherlands are a logistics hub for German exporters. Consequently, shrinking global trade has also left its mark on exports. Aggregated exports to the euro area edged up only a marginal c. ½%. With the exception of Italy, exports to the major euro countries across the board rose. If goods exports to Italy continue to shrink in 2020, Austria might overtake Italy to become the third-largest export market in the euro area and the sixth-largest worldwide. For 2020, we expect export growth to remain sluggish, with rates as in previous years slightly undershooting those of aggregate exports.

UK exports to be supported by diminishing uncertainty and stabilising pound sterling

The uncertainty surrounding Brexit left its impact on exports during the year. In spring and summer 2019 – the phases of intensive debate about a hard or even chaotic Brexit – sales slipped strongly, but rebounded in early and late 2019. As the Conservatives secured a comfortable majority in the House of Commons election in December, uncertainty is likely to diminish further in 2020. With the likelihood of further depreciation in the pound thus decreasing, exports to the UK would be supported. According to current plans, the UK and the EU have time to secure a trade deal by the end of 2020. At the crux of negotiations are the potential border controls between Ireland and Northern Ireland, along with the question of whether free movement of goods, services, capital and people will be incorporated in the new deal. How exports to the UK are impacted will diverge strongly, depending on the scenario. First, negative effects would probably resume should uncertainty be rekindled and if another Brexit deadline were postponed. Relative to the previous years, however, this effect might be milder, as some business decisions against the UK have already been made over the past few years, and many companies have prepared contingency plans to counter the disruptions caused by a hard Brexit. Second, front-loading effects are a likely scenario should the new deal point to higher trade barriers. A free trade agreement that underlines the to-date tight economic relations between the two economic areas would be the most favourable outcome. In this case, strong catch-up effects are to be expected, not least due to weak demand from 2016 to 2018.

Emerging markets, in particular the Visegrad countries, support exports

The Visegrad countries – Poland, Czech Republic, Hungary and Slovakia – are a key growth market for German exporters. In aggregated terms, German goods exports to these countries have exceeded those to its largest export partner, the US, since 2007. Since then, they have gained in importance, partly because competition has turned fiercer. Given the cost-related downsides of German production sites (e.g. labour costs, corporate taxes, electricity prices), Germany's exposure to these countries is likely to strengthen. In the past, imports and exports to the Visegrad were closely correlated. If, however, German companies continue to move production abroad, entire production chains could be specifically outsourced to the Visegrad countries and German car sales would, in part, come from production at these sites. As a result, German exports to other coun-

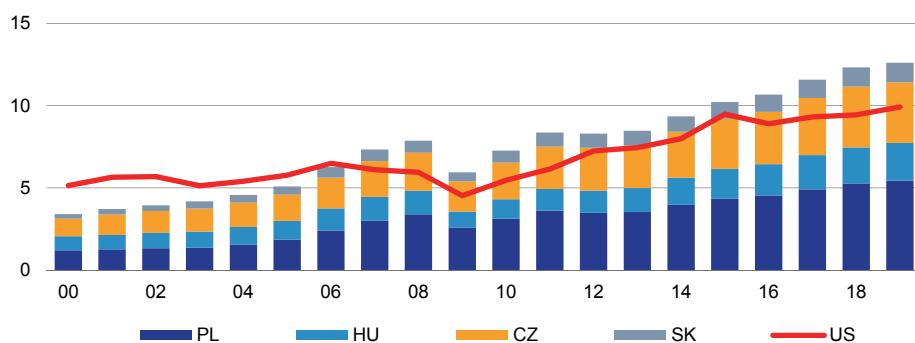


tries might be dampened. The trend towards e-mobility should accelerate the restructuring process, as the investments required cannot be realised unless costs are cut. We therefore expect exports to these countries to continue to rise strongly in 2020.

Bilateral exports: Visegrad countries vs. USA

13

in EUR bn per annum



Sources: Deutsche Bank Research, Federal Statistical Office

But exports to many other emerging countries are highly volatile

Exports to Turkey declined for the fourth year in a row, but rebounded in the second half of 2019, thanks to the stabilisation of the Turkish lira and better economic data. This trend ought to continue in 2020 – provided no further US sanctions are imposed and geopolitical tensions can be avoided. Sales to Russia followed a similar pattern, with the appreciation of the rouble and brighter economic data pushing up exports in the latter half of 2019. Without new geopolitical tensions, another slight uptick should be possible in 2020, even if current sanctions on Russia are extended on 15 March 2020. A sharp deterioration in oil prices, on the other hand, would weigh on German exports to Russia. Looking ahead, Russia, which is currently Germany's fourteenth-largest trading partner, could gain in importance, if the recent rapprochement between Russia and the Ukraine paves the path to peace. Before EU sanctions were introduced in 2014, Russia was close to entering the "top ten"; for German mechanical engineering, it even moved up to No. 4. If catch-up effects actually materialise, growth rates of well over 10% are likely. Exports to many Arabian countries declined sharply in 2019, some at double-digit rates, and are likely to shrink further or stagnate, at best, in 2020, led by the oversupply in global crude oil markets. Despite German industry's export strength, exports to non-European emerging markets continue to be relatively minor. The major markets are Mexico at No. 22, followed by India at No. 25, Brazil at No. 28 and South Africa at No. 29. Even though exports to the above countries are rising strongly, their respective share of all goods exports is less than 1%.

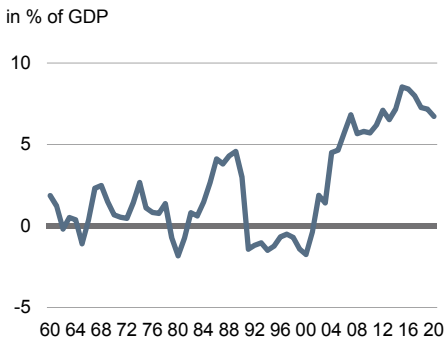
Current account surplus shrinking only slowly

The current account surplus looks set to have declined only moderately in 2019, down to 7.2% of GDP or roughly EUR 245 bn. Marking the fourth consecutive contraction (2015: 8.6%, 2016: 8.5%, 2017: 8.1%, 2018: 7.4%), the surplus is shrinking steadily, albeit slowly. For 2020, we expect a continuation of this trend and a surplus of 6 ¾% of GDP. Of the major countries, Germany continues to be one of the main sources of global imbalances, though this is the decision of



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1960-2020: Current account 14



Sources: Federal Statistical Office, Deutsche Bank Research

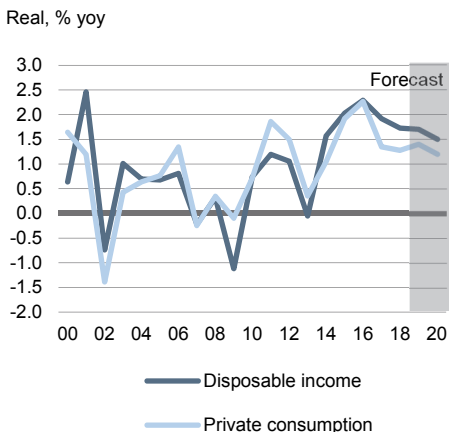
millions of individual economic entities rather than the result of an economic policy strategy. Given the expected further contraction of surpluses in 2020, the growth contribution of net exports will likely be negative again. In the years ahead, real exports should continue to expand at a slower rate than imports. This trend could persist, not least because of demographic effects that emerged years ago.

Structure of current account more or less unchanged

Key features of the current account have been in place for years, and subcomponents were more or less unchanged in 2019 as well. High surpluses in the goods account and positive primary income are still accompanied by deficits in the services and transfers accounts. Moreover, bilateral current account surpluses have shrunk only marginally. The only notable exception are surpluses vis-à-vis the euro countries and the EU states, which declined by c. 10% each, down to EUR 75 bn and 100 bn, respectively. Surpluses vis-à-vis the US, on the other hand, soared to a new all-time high of EUR 75 bn, led by the strong performance of the US economy and heightened uncertainty with regard to the future path of US trade policy. The resulting strength of the US dollar tends to boost German sales prospects. In the upcoming years, the evolution of surpluses will largely hinge on US trade policy and, as described above, on whether the US imposes tariffs on car and auto part imports from the EU. As far as we know, no deadlines are currently pending in this respect. But the issue is likely to be back on the table when negotiations between the US and the EU resume.

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Disposable income and private consumption 15



Sources: Deutsche Bundesbank, Deutsche Bank Research

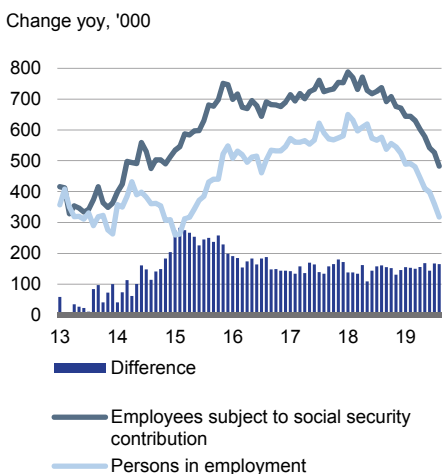
Private consumption remains the most important contributor to growth in 2020

Growth in private consumer spending is likely to slow slightly to 1.2% in 2020, while an increase of 1.5% is expected for 2019. The contribution to growth would thus be 0.8 percentage points this year and 0.6 percentage points in 2020. Important drivers of the positive development in the past year were the upward trend of both employment and wages, but also fiscal policy measures as well as catch-up effects in passenger car purchases. Together with construction investments (estimated growth contributions of 0.4 percentage points in 2019 and 2020 as well), private household consumption should continue to drive the domestic economy in the coming year.

The slight slowdown that we anticipate in 2020 is due to weaker wage growth. Against the backdrop of the weaker economic developments, the results of the coming collective bargaining round (for around 10 million employees) will be somewhat more restrained. Hence, it is likely that growth in negotiated wages will be around 2 ½% in the coming year, after around 3% in 2019. In addition, the statutory minimum wage will be raised from EUR 9.19 to EUR 9.35 in Jan.

In the coming year, private household spending should also benefit from the sharp rise in pensions on 1 July (West Germany: 3.15%, East Germany: 3.91%)¹. In addition, there are increases in basic and child allowances and the adjustment of the income tax rates to compensate for the "cold progression".

Ongoing but slowing employment growth 16



Sources: Federal Employment Agency, Federal Statistical Office, Deutsche Bank Research

¹ As a result of the latest general revision of the national accounts, gross wages and salaries have also been revised. According to the pension formula, this would have resulted in an extraordinary

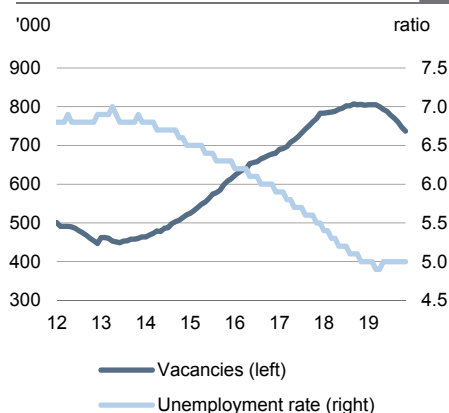


The continuing favourable financing conditions should also support private consumption. This applies as well to the decrease in the annual inflation rate (2019: 1.4% and 2020: 1%), which supports real purchasing power.

Compared to H2 2018 (11.1%), the savings rate in H1 2019 fell to 10.8%. Problems with the introduction of the WLTP standard led to delivery bottlenecks for passenger cars in 2018. The car purchases postponed as a result were made up for at the beginning of this year and are likely to have led to this development. In light of the ECB resuming the asset purchase program and banks passing on negative interest rates to consumers, the propensity to save fell noticeably towards the end of the year, according to the GfK survey. In this environment, the savings rate is likely to fall slightly below 10.8% in the coming year.

Labour market: Near full employment but cyclical skid marks

17

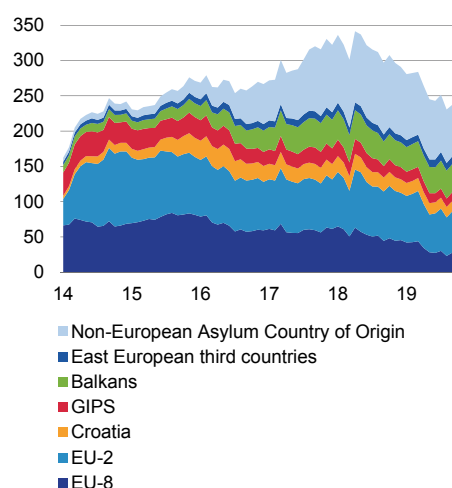


Source: Deutsche Bundesbank

Employment driven by migration is moderating

18

Change yoy ('000 persons)



Sources: Federal Employment Agency, Deutsche Bank Research

German labour market – marked slowdown in momentum

The German labour market developed solidly in 2019 despite the weak economic phase. This is attributable in particular to the domestically oriented sectors, which have so far been affected very little by the foreign-trade-related headwinds. With 45.3 million employees (+0.9% yoy), a new record high will be reached this year. Compared to 2018 (+1.4% yoy), however, growth lost momentum as expected. It is worth noting that the overall increase in employment above all occurred in employment subject to social insurance contributions. The upward trend was supported by immigration. In the past 12 months (as of September), the contribution to the increase in the number of persons employed averaged around 270,000².

Over the course of the year, the unemployment rate even fell to 4.9% for two months, helped by active labour market policy measures. The annual average will be at 5%.

Labour market outlook 2020

The decisive factor for labour market development in 2020 will be the end of the recession in German industry. At present, leading sentiment indicators are signaling that the bottom could be reached at the beginning of next year. The "dichotomy" of the German economy, with an upward trend in the services and construction sectors but a more sideways trend in industrial production, is likely to continue for the time being. Against this backdrop, a further reduction in the number of industrial workers is to be expected. This is likely to affect temporary workers in particular, while skilled workers are still in demand.

As the labour market usually reacts to economic developments with a lag of around six months, the manufacturing industry in particular is still expected to have a negative impact on employment development. The corresponding sub-components of the purchasing managers' indices (PMIs) and the ifo employment barometer also signal a further decrease in the number of industrial workers in the quarter ahead. Despite the prolonged industrial recession, the overall impact on the labour market in this phase of economic weakness has so far

increase of about 2% in 2020 via the "wages" factor, in addition to the adjustment due to the 2019 wage increases. In 2021 this effect would then have been reversed according to the formula. To avoid such a "yo-yo effect", a corresponding legislative amendment was introduced. (Bundesgesetzblatt No. 39, 20. November 2019).

² Immigration from the new Eastern European EU member states, the GIPS states and the other migration countries (non-European countries of origin of asylum seekers, Western Balkans and Eastern European third countries).

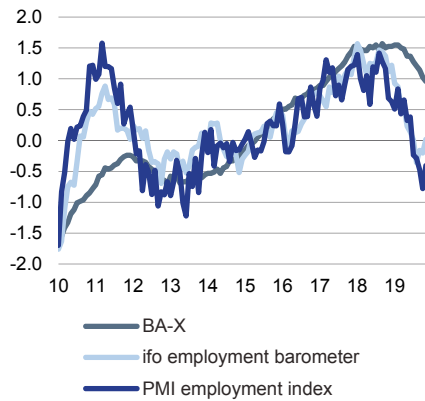


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Companies show a cautious attitude to hiring

19

Standardised values (since 2009)



Sources: Federal Employment Agency, ifo, IHS Markit, Deutsche Bank Research

been rather limited. Compared with the recession of 2009, the domestically oriented service sector has gained in importance, making the labour market more independent of cyclical economic developments. However, the employment boom of recent years has led to a general shortage of qualified workers. It is therefore plausible, even for the weak industrial sectors, to maintain their workforce and, whenever possible, avoid large-scale layoffs. This is all the more true in view of demographic change. In particular, the retirement of the "baby boomers", which begins in the mid-2020s, will noticeably reduce the labour force.

Leading indicators for the German labour market (IAB and ifo barometers) also point to a further upward trend in employment, albeit at a weaker pace than in 2019. For 2020, we expect an increase in the number of people employed of about 130,000 (+0.3%), after just under 400,000 in 2019 (+0.9%). Survey results for the services sector (PMIs and ifo) as well as for construction point to rising employment figures and support this forecast.

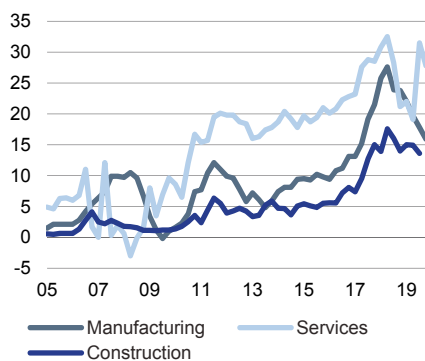
To adjust their labour input, companies affected by economic headwinds are likely to continue making use of flexible working hours. These include working time accounts, the reduction of overtime or short-time work. In addition, headcount can be adjusted by not filling vacancies. We expect the unemployment rate to rise slightly to 5.1% in 2020.

At the lower end of the wage spectrum, persistent rising cost pressure could lead to productivity falling below the minimum wage level, thus leading to negative employment effects. So far, this has probably failed to materialise because companies have, for example, reduced contractual working hours, increased workload or simply increased prices to adapt. Of course the latter instrument, price increases, is of limited value in periods of economic weakness.

Labour shortages still pressing but easing

20

Labour shortage as limiting factor, share of companies, %



Source: EU Commission

Collective bargaining round in 2020

In the collective bargaining round in 2020, new agreements will be negotiated for around 10 million employees, just under 30% of the 33.6 million employees subject to social security contributions. The focus is likely to be on the forthcoming negotiations in the metal and electrical industries (3.8 million), scheduled to begin in April, and the negotiations for the public service of the federal government and the municipalities (2.7 million), starting in September. Other major collective agreements include temporary employment agencies (just under 1 million) and the construction industry with about 633,000 employees.

Due to the economic weakness in the manufacturing industry, the outcome of negotiations in the metal and electrical sectors is likely to be more restrained in 2020 than in 2018 (+4.3% plus collectively agreed supplementary payments). The most recent contracts in the chemical industry of less than 2% could be an indicator. Flexible working hours and on-the-job training are likely to become additional negotiating elements. In the collective bargaining agreements in the public sector of the federal government and the municipalities, the demands are likely to be based on those of the 2018 collective bargaining round for state employees. Since the public sector competes with other sectors for skilled workers, agreements of a good 3% are likely to be negotiated above all for the middle wage groups or in their lower wage brackets.

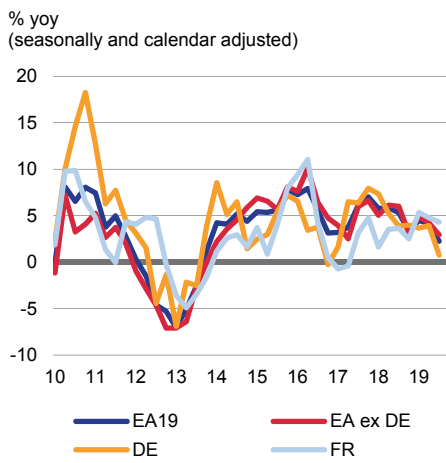
Overall, with the collective wage agreements for 2020 likely leading to an increase of around 2 ½%, together with the increase in monetary social benefits (old-age pensions) and the modest growth in employment, the nominal disposable incomes of private households should rise by just under 3%. In view of the 1% inflation rate we expect, real disposable incomes are likely to rise by a good 1 ½% in 2020.

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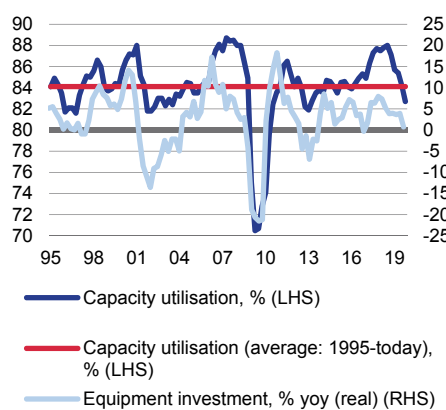
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Real equipment investment **21**



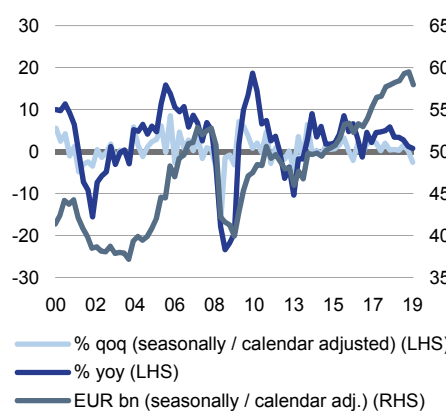
Sources: Eurostat, Deutsche Bank Research

Equipment investment (gross) vs. capacity utilisation of the industry **22**



Sources: Eurostat, European Commission, DB Research

Real investment into equipment **23**



Sources: Federal Statistical Office, Deutsche Bank Research

Investments in equipment

German investments in equipment hampered by weak global trade, trade risks and industrial slump ...

The cooling of the global economy (industrial slump, declining global trade) and the high level of political uncertainty continue to damage investments. Trade conflicts, in particular, are curbing the willingness of many export-driven industrial companies involved in global value chains to invest, as they make the political framework conditions for foreign trade (tariff rates, import quotas, trade restrictions) uncertain. Growth in investments in equipment (machinery, equipment and vehicles) in both developed and emerging economies has continued to cool noticeably over the course of the year to date (see chart 21).

According to the economic survey carried out by Germany's Association of German Chambers of Industry and Commerce (DIHK)³ (from autumn 2019), almost half of the industrial companies surveyed – in line with the highest figures recorded since the surveys began in 2010 – view the economic policy environment as a risk to their business development. Foreign trade risks (unresolved trade conflict, Brexit, weak global growth) are evidently unsettling industrial companies to an increasing extent. The noticeable deterioration in business and export expectations (well below long-term averages) has prompted companies to act much more cautiously.

In response to the gloomy business climate, industrial companies once again significantly lowered their investment and employment intentions in the autumn. In total, the number of industrial companies that want to reduce their investment budgets over the next 12 months outweighs those that are planning higher investments in the future (in net terms: -4% of companies surveyed; cf. economy as a whole: 26% higher / 21% lower / 5% net). Producers of capital goods, which are particularly exposed to global fluctuations in demand, have revised their investment plans downwards particularly sharply (in net terms: -10%)

.... but the energy transition is also unsettling businesses

The motives of investment in the domestic economy are more focused on replacement needs (65%) and rationalisation and environmental protection measures (32% and 19%, respectively), while measures to expand capacity (26%) have lost importance, which is not surprising given the decline in the industrial sector's capacity utilisation rate (see chart 22). In addition to the weaker (global) economy and the high level of political uncertainty, around half of industrial companies consider the shortage of skilled workers to be a business risk (48%). However, the main business risk mentioned by most industrial companies, and the factor most curbing investment, remains domestic demand (rising to 57% from 37% in autumn 2018). Yet the energy transition and the resulting uncertainty about the coming trends in energy prices also seem to be unsettling companies.

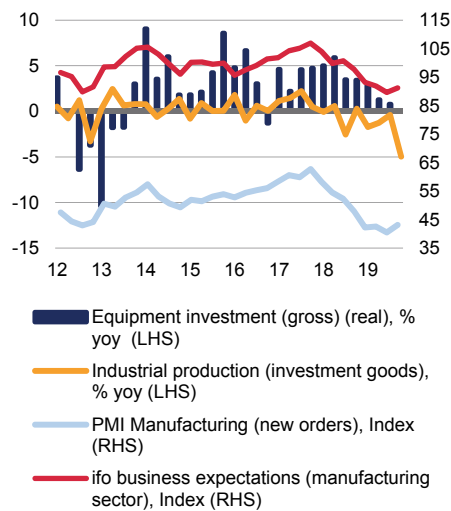
³ See DIHK economic survey, autumn 2019. Economic downturn.



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Challenging times for equipment investment

24



Sources: Federal Statistical Office, Deutsche Bank Research

Since the beginning of the US-Chinese trade conflict, there has been hardly any movement in investment in equipment

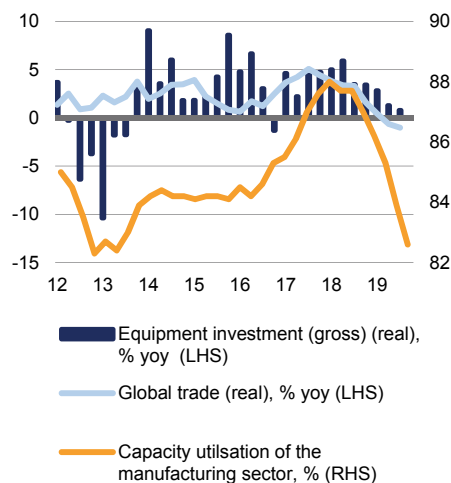
Since the beginning of 2018, i.e. more or less when the US-Chinese trade conflict began, investment in equipment (real, i.e. price-adjusted) has barely moved upwards (see charts 23 and 25). In the third quarter of 2019, it even shrank by 2.6% compared to the second quarter, although this decline can essentially be attributed to special effects, i.e. a sharp decline in government investment in equipment (-33% year on year after an increase of just under 50% in the second quarter). However, private investment in equipment also rose only slightly in the third quarter (+0.7% year on year), following a decline of more than 3% in the second quarter. The annual growth rate of investments in equipment has slowed considerably over the past two years, from 5.9% (Q2 2018) to a meagre 0.8% (see charts 24 and 25).

Tailwind from previously high capacity utilisation lost, sharp decline in investments in H2 2019

While the capacity utilisation rate in the third quarter of 2018 was still 88%, it fell to just 82.7% by the final quarter of 2019, placing it once again below the long-term average of around 84% (see chart 22). Despite exceptionally favourable financing conditions, we believe that the negative factors will prevail in the short to medium term. Among the factors hampering investment are increasing protectionism and the associated risks (e.g. the risk of tariffs on European motor vehicles), the increasing shortage of skilled workers in Germany, the growth slowdown in important export markets (e.g. China) and technological changes in important key industries (e.g. automotive). All of these factors are bringing about structural upheavals and therefore uncertainty for businesses. Current leading indicators, such as the Ifo Business Climate Index or the purchasing manager indices for the manufacturing industry, do not yet signal a turn for the better in terms of growth. On the contrary, the gloomy business expectations of companies in German manufacturing industry and industry-related service companies indicate that investment in equipment by the non-government sector is likely to shrink significantly in H2 2019. We expect equipment investment (total economy) to decline by another 0.5% in the final quarter of 2019. The first quarter of 2020 could see another decline of 0.25% (see chart 26).

Equipment investment vs. global trade and capacity utilisation

25



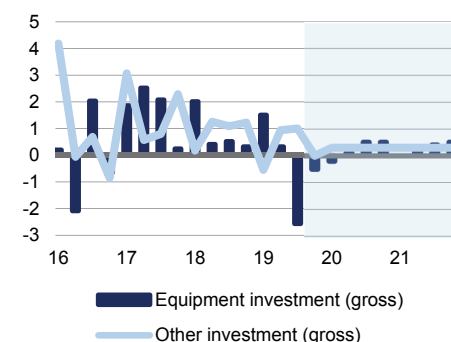
Sources: Federal Statistical Office, Deutsche Bank Research

Outlook for equipment investment 2020/21: No noticeable recovery in sight!

Equipment investment should remain weak

26

% qoq (seasonally / calendar adjusted)



Sources: Federal Statistical Office, Deutsche Bank Research

Investment activity is likely to remain sluggish at the beginning of 2020 and only return to a slightly expansive path from the second quarter onwards (towards a growth rate of around 0.5% per quarter) (see chart 26). A stronger stimulation of investment would require the elimination of current risks (such as a no-deal Brexit, potential US trade tariffs on vehicle exports to the US, uncertain political conditions in Italy/Spain/Germany). Based on the annual growth rate, we expect German investment in equipment to have grown by an average of 0.7% in 2019 (after an average of just under 4% between 2015 and 2018). In 2020, it is even likely to fall by 0.5% on average for the year, before rising again – by a slight ~2% in 2021. A significant revival of the global economy and world trade remains the basic prerequisite for a return to greater momentum in capital goods.

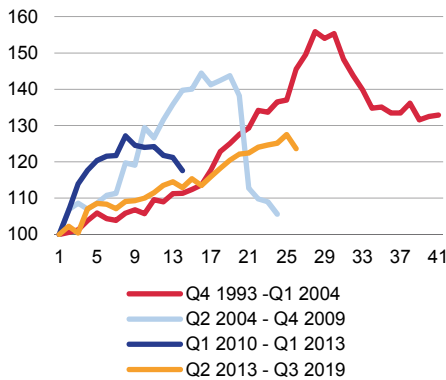


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Equipment investment in the non-economic cycle

27

Index: 100=starting point in the cycle

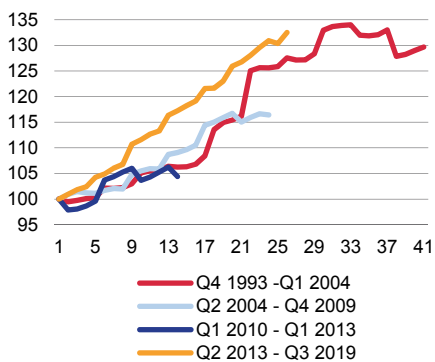


Sources: Federal Statistical Office, Deutsche Bank Research

Other investment in the non-government economic cycle

28

Index: 100=starting point in the cycle

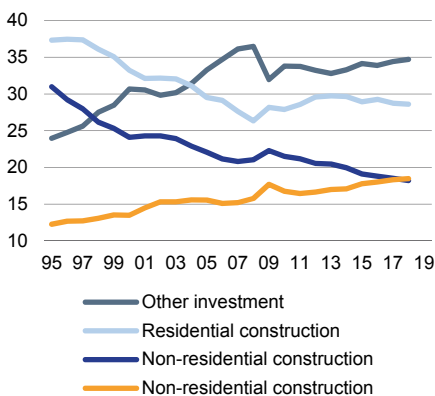


Sources: Federal Statistical Office, Deutsche Bank Research

Other investment have become gained gradually in importance

29

% shares in gross fixed investment (based on price adjusted and chain-linked values)



Sources: Federal Statistical Office, Deutsche Bank Research

Is Germany investing too little and thereby risking its future sustainability?

The claim: Companies' investment rate is poor – government "letting things deteriorate"

At home and abroad, the assumption is often put forward that Germany is increasingly letting its (public) infrastructure deteriorate and is dramatically losing competitiveness. In view of high current account and budget surpluses, Germany is being accused of not investing enough. German companies have often been accused of low levels of investment, which is reflected in the relatively weak development of investment in equipment – particularly in view of past economic cycles. It is therefore important for policymakers to stimulate business investment in a targeted manner, for example by improving framework conditions, increasing tax incentives for investment or subsidies.

But the government itself has also been criticised for its investment activities. It is accused of living on the substance of its public infrastructure for many years, if not decades, and of increasingly letting its capital stock deteriorate (e.g. roads, railways, public buildings, etc.). The German Institute for Economic Research (DIW Berlin), for example, has for many years identified a considerable public "investment gap" in Germany, which must be closed as far as possible through major governmental efforts. In view of allegedly considerable public investment and infrastructure deficits, the government is being called upon to finally make significant increases in growth-oriented expenditure (particularly in transport infrastructure, climate protection, digitalisation, education, and research and development) to keep pace with other countries in the increasingly competitive global economic environment.

With regard to the direction of fiscal policy, the German government is accused of putting the country's future viability and therefore future prosperity at risk by clinging to the "Schwarze Null" ("black zero") policy (a balanced federal budget). In view of zero/negative interest rates for the German treasury, the critics of Germany's fiscal policy are of the opinion that the government is being downright negligent in its refusal to embark on a credit-financed investment campaign. They are assuming long-term loans at zero interest rates and a strengthening of Germany's growth potential, including positive spillover effects for the eurozone and the rest of the world. In this context, it is often argued that a large-scale, credit-financed public investment programme would not be problematic from a sustainability perspective, as the interest rate growth differential – a crucial variable for the future development of the public debt ratio – is clearly negative.

According to these critics, the debt brake enshrined in constitutional law should also be abolished or at least reformed (e.g. excluding public investment), since it impedes the government's investment activity and thereby artificially limits growth potential ("investment brake"). They are suggesting an alleged conflict of objectives or contradiction between sound public finances and higher investments. Even the German Institute (IW), which has close ties to employers' associations, is calling for some adjustments to the debt brake and has proposed the establishment of a "Germany Fund" with a volume of up to EUR 450 billion over the next ten years. This demand now seems to have been adopted by the new SPD leadership.

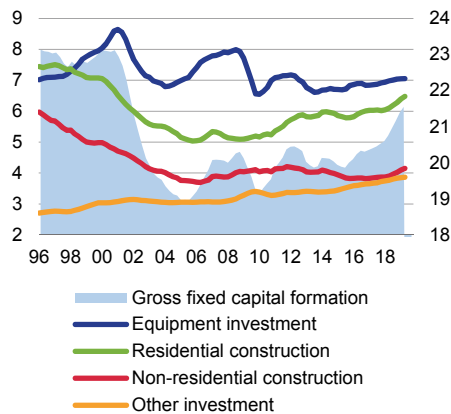


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The German investment ratio has been rising for a couple of years already

30

% of GDP (moving annual averages)



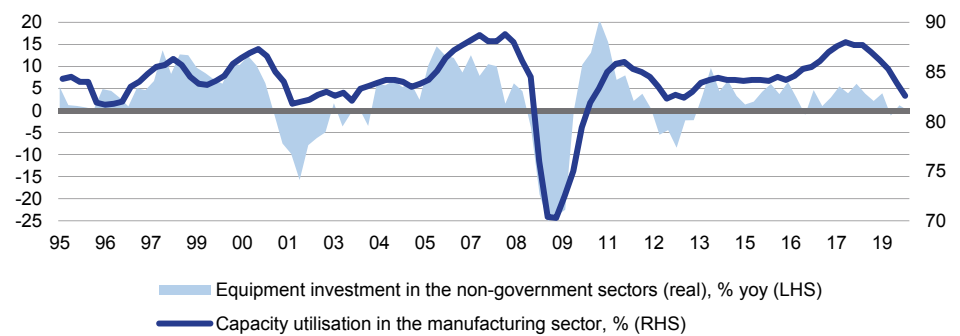
Sources: Federal Statistical Office, Deutsche Bank Research

The facts: No weakness in corporate investment discernible – significant increase in government investments made

A look at the investment activity of the non-government sector since the beginning of the 1990s reveals that investment in equipment in particular has developed much more slowly in the current economic cycle than in previous cycles (see chart 27). Against the backdrop of relatively high capacity utilisation (before the beginning of the current industrial recession), (real) growth in equipment investment has been relatively weak (see chart 31).

Equipment investment in the non-government sectors vs. capacity utilisation

31

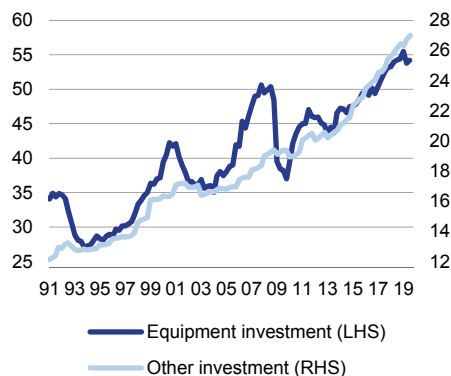


Sources: Federal Statistical Office, Deutsche Bank Research

Equipment vs. other investment (non-government sectors)

32

EUR bn (real) seasonally and calendar adjusted



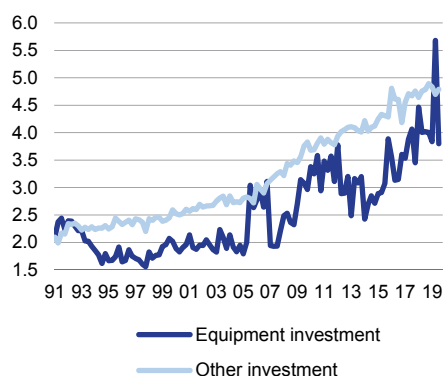
Sources: Federal Statistical Office, Deutsche Bank Research

However, whether this development is evidence of weak investment by German companies can only be answered – if at all – with reference to additional indicators. It is interesting to note in this context that other investments (i.e. in intellectual property, research and development, software and databases) have never been as strong as in the current economic cycle (see chart 28). The importance of these intangible investments is constantly rising: their share of total gross fixed capital formation has risen from around 12% in 1995 to 18.5% in 2018. This means that today this investment is at a similarly high level to investment in non-residential construction (roads, commercial buildings, etc.) (see chart 29). It is therefore a plausible scenario that the weaker momentum in investment in equipment, which was accompanied by higher momentum in other investments, is largely a reflection of the (digital) structural change.

Equipment vs. other investment (government sector)

33

EUR bn (real) seasonally and calendar adjusted



Sources: Federal Statistical Office, Deutsche Bank Research

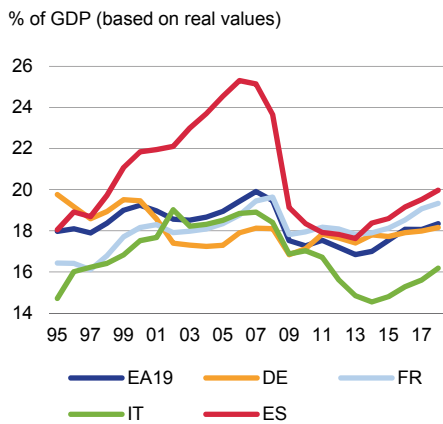
In principle, private investment decisions will be made on the basis of return considerations. On the basis of available macro data from national accounts, a politician or scientist is unlikely to be a better judge than the companies themselves as to whether they are investing enough and sensibly. We would still like to examine the arguments for and against a slowdown in business investments on the basis of established parameters.

In terms of the investment ratio (gross fixed capital formation to GDP), the German investment ratio has been rising for several years and currently stands at around 21.5% (see chart 30), putting it higher than the values prior to the global economic and financial crisis, but still below the level of the mid-1990s. In general, assessing investment activity on the basis of investment ratios is problematic as it is not possible to determine the optimal investment ratio (i.e. the ideal situation for investment). We can only make comparisons with past episodes or between countries – which must be interpreted with caution due to country-specific circumstances (e.g. reunification boom in Germany in the 1990s, construction boom and real estate market bubble in Spain in the 2000s).



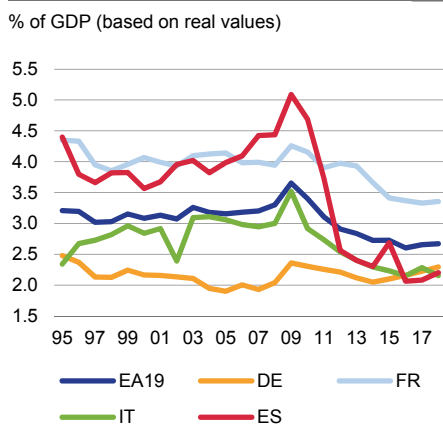
Fragile – handle with care

Gross fixed capital formation:
Non-government sectors 35



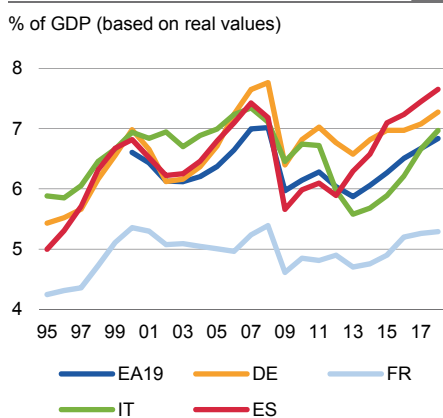
Sources: AMECO, Deutsche Bank Research

Gross fixed capital formation:
Government sector 36



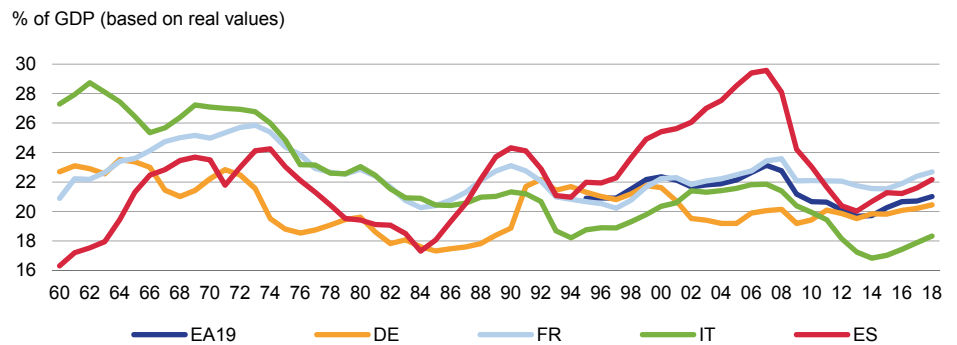
Sources: AMECO, Deutsche Bank Research

Gross fixed capital formation:
equipment (total economy) 37



Sources: AMECO, Deutsche Bank Research

Gross fixed capital formation: total economy 34



Germany: West Germany before 1991

Sources: AMECO, Deutsche Bank Research

Another weakness of nominal investment ratios is that they can shift either upwards or downwards depending on price effects. In principle, the real development of (gross) investments is decisive for the formation of capital stock rather than the mere amount of money that has been spent on it. For example, the investment ratio for capital goods (machinery, vehicles) in Germany, which is based on nominal values, has fallen sharply since 1991. As a result, it is now at around 6.6% and well below the figure of just under 10% in 1991 (see chart 38).

A closer look reveals that until the end of the 2000s the ratio was shifted sharply downwards by the declining price trend for equipment goods. Even today, prices for equipment goods continue to rise only very moderately and noticeably more slowly than prices for the economy as a whole (measured by the GDP deflator) (see chart 39). Excluding these relative price effects for equipment goods, the (real) investment ratio has developed much more favourably. Even though this investment ratio is still well below the level before the global financial and economic crisis, it has risen since the mid-1990s and is above the 1991 level. It is also clear that the trend growth in the equipment investment ratio on the basis of real values was much stronger than when nominal values were taken into account (see chart 38).

For this reason, it makes sense to consider real investment activity as follows. As shown in charts 32 and 33, real investments in equipment and other investments for both public and private sectors are – despite the current weakness in growth – currently higher than before the global financial crisis. However, a glance at the investment ratios adjusted for price effects (ratio of real investment to real GDP) also shows that German investment has been following an upward trend for several years. This upward trend is evident for the economy as a whole as well as for the non-governmental sectors and the government (see charts 34, 35 and 36).

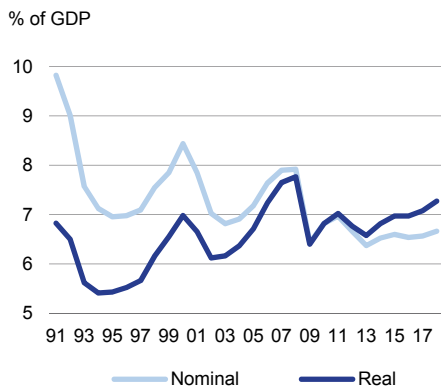
Even if the government investment ratio is lower than in other eurozone countries, it cannot automatically be inferred that the German government is not investing enough as this assumes that the other countries have reached an optimal investment level (and Germany has not). Similarly, the comparison of public investment ratios across countries remains problematic due to the different distribution of tasks between the public and the private sectors. For example, the French government investment ratio is likely to be higher than the German one in part because many hospitals, for instance, are publicly funded rather than privately funded (as they are in Germany). In the US, public investment is likely to be higher than in Germany, partly due to significantly higher investment expenditure in defence.



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Germany: Gross fixed capital formation - equipment

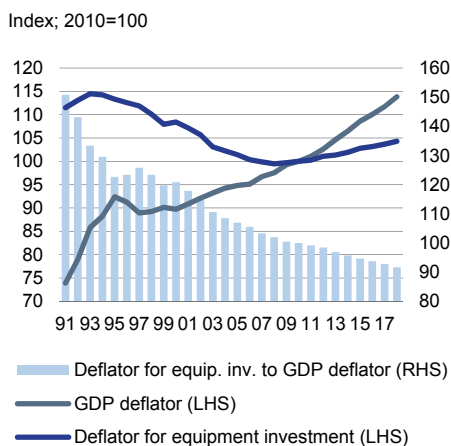
38



Sources: AMECO, Deutsche Bank Research

Germany: Deflator for gross fixed capital formation

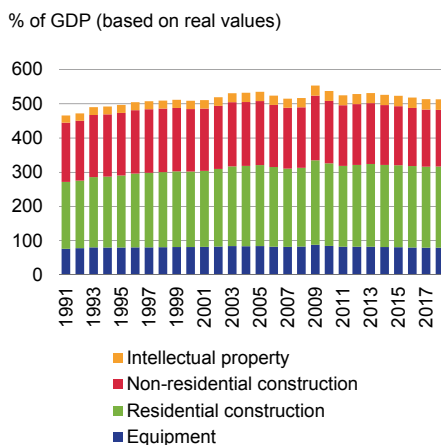
39



Sources: AMECO, Deutsche Bank Research

Gross fixed assets (at replacement costs): Total economy

40



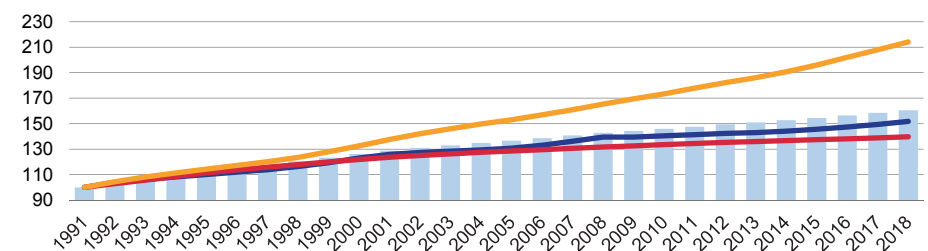
Sources: Destatis, Deutsche Bank Research

And finally, the level of capital stock in an economy as well as the capital intensity (i.e. the amount of physical capital relative to the working population) can also be taken into account. For example, a decreasing (real) capital stock or declining (real) capital intensity could indicate insufficient investment activity and with it a drop in capital resources. There is no obvious cause for concern at first glance based on the development of the capital stock used throughout the German economy (real ratio to GDP). Although the capital stock has declined slightly in relation to GDP since the financial crisis, it is higher than in the early 1990s (see chart 40).

Gross fixed assets (at replacements costs): Total economy

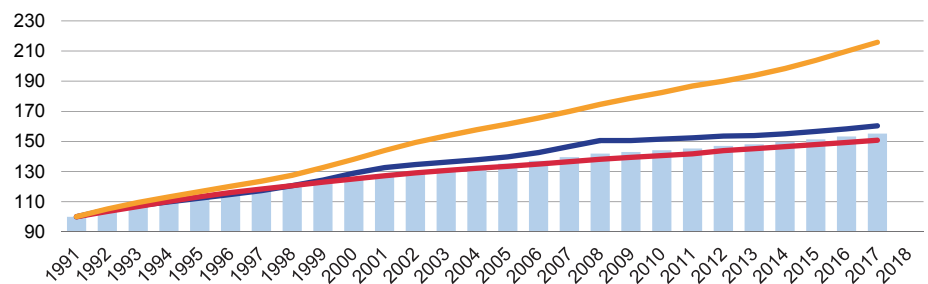
41

Index: 1991=100 (real)



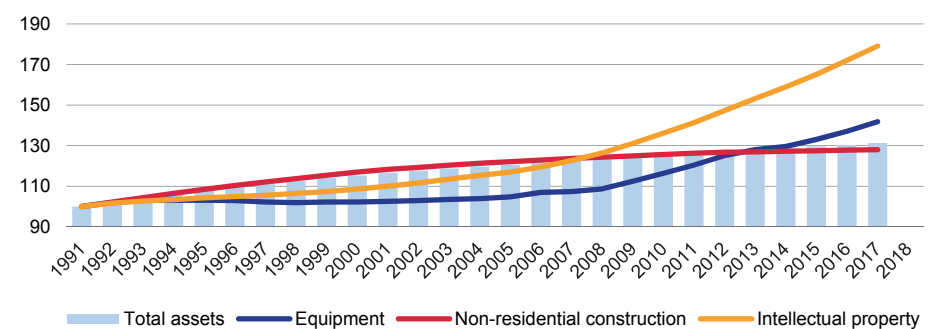
Non-financial corporate sector

42



Government sector

43



Sources: Federal Statistical Office, Deutsche Bank Research

As in most other economies, German capital stock is strongly influenced by residential construction (apartments, houses) as well as non-residential construction (roads, public buildings, commercial buildings), which together account for almost 80% of the capital stock. Investments in equipment and other investments have shares of around 15.5% and 6%, respectively. While the share of equipment investment has decreased slightly since the beginning of the 1990s (1991: 16.4%), other investments have noticeably increased (1991: 4.5%).

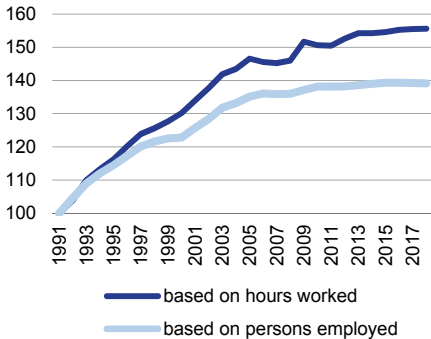


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Capital intensity: Total economy (total gross fixed assets)

44

Index: 1991=100 (real)
Gross fixed assets per labour input



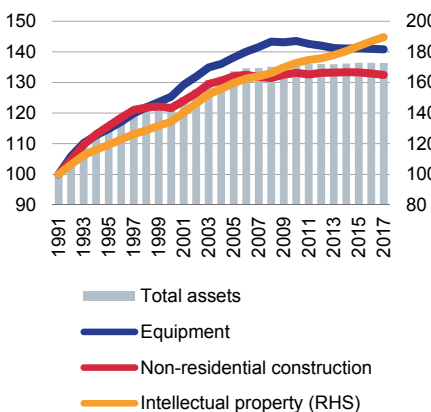
Sources: Federal Statistical Office, Deutsche Bank Research

The (real) capital stock, measured as gross fixed assets at replacement prices, has risen steadily since 1991 both for the economy as a whole and for the business sector (here approximated by the non-financial corporations sector) and for the state. Furthermore, this observation applies to all capital goods, although it is noticeable that the other investments have grown most dynamically. It also shows that the government's gross fixed assets in non-residential construction (roads, motorways, administrative buildings) have been growing only very slowly for several years (see chart 43). This could indicate that the German government did not invest enough in non-residential construction in the past. However, it is also clear that the German government is currently increasing its investments in this area significantly. Investments in public construction projects are currently growing faster than they have in a long time. Prices for investments in public construction projects are already rising more sharply than at any point since the mid-2000s due to high capacity utilisation and the increasing shortage of skilled workers in the construction industry (see chart 46). We therefore believe that even higher investments in construction projects at this time would be counterproductive.

Capital intensity: Non-fin. corporate sector (total gross fixed assets)

45

Index: 1991=100 (real)
Gross fixed assets per person employed

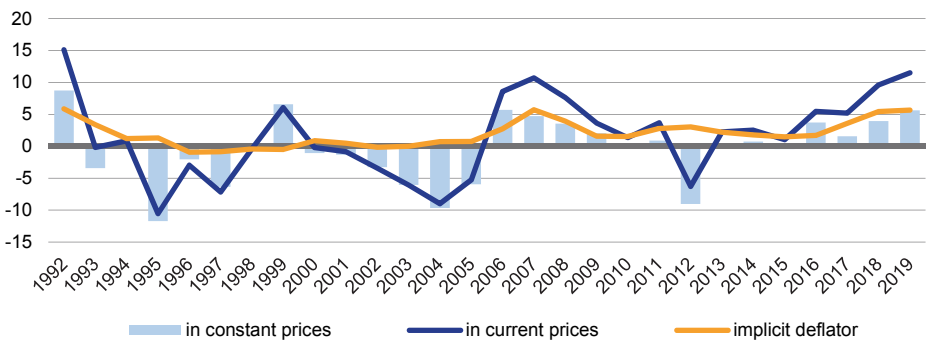


Sources: Federal Statistical Office, Deutsche Bank Research

Public construction investment

46

% yoy



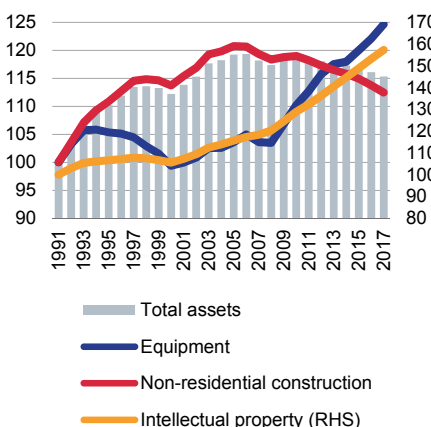
2019: Q3 2019 vs. Q3 2018 based on moving annual sums

Source: Federal Statistical Office

Capital intensity: Government sector (total gross fixed assets)

47

Index: 1991=100 (real)
Gross fixed assets per person employed



Sources: Federal Statistical Office, Deutsche Bank

The development of capital intensity does provide cause for concern for the German economy as a whole, even though it is increasing only very slowly based on the number of hours worked and is more or less stagnating based on the number of people employed. Similar trends can be seen in the issuing of equipment investments, where the capital intensity based on the working population has (slightly) declined ever since the global financial crisis. On the other hand, other investments are increasing steadily and with momentum. This applies both to companies (non-financial corporations) and to the public sector. However, there are different development trends in terms of equipment between companies and the government. While the capital intensity of equipment has risen strongly for the government sector, it has stagnated over recent years in the non-financial corporate sector. Falling capital intensity for public non-residential construction points to a need to renew parts of the physical infrastructure.

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Digital policy: Thinking big, acting small

Warnings about the rapid pace at which Europe and Germany are falling further behind the US and China in the global digital race have become so common that they hardly hit the news anymore. Still, the fact that almost all big techs and the majority of innovative “unicorns” are either in the US or China should put European leaders on permanent high alert. And indeed, like their counterparties across European capitals, the German government has published detailed analyses of the underlying drivers of this growing discrepancy as well as ambitious strategies to tackle the issue

But despite the continuous lip service over the past years to make Germany a major player in the global platform economy, when it comes to the implementation of the government’s strategy, two essential factors remain in notoriously short supply: money and speed.

The German institutional framework for digital policy already illustrates many of the shortcomings. Despite repeated calls for a German digital ministry, the government coalition of CDU/CSU and SPD decided after the 2017 elections to keep the responsibilities and competencies for digital transformation distributed among several ministries. Since 2018, digital efforts are coordinated by a “Minister of State for Digitisation” in Merkel’s Chancellery. But as there is no digital ministry there is no such thing as a “digital budget” independent from the budget of the various ministries. So it cannot easily be determined how much exactly Germany spends on digital infrastructure etc. In addition, given the overlapping responsibilities of several ministries on digital policy, unfocused spending without clear priorities is a serious issue. The call for a digital ministry has been taken up again by CDU party leader Kramp-Karrenbauer but it's fair to doubt whether the next government coalition will be more able and willing than the current one to agree on a concentration of digital competencies under just one roof.

While Germany gradually moves forward with its “digital-made-in.de” agenda, shortcomings and uncompleted projects line the way

Germany continues to lag behind peers regarding its digital infrastructure as the expansion has been carried out more slowly and less comprehensively than politically intended. A special “digital infrastructure” fund was created in 2018, with an initial financing of EUR 2.4 bn and funded through the release of EUR 6.5 bn from the auction of 5G licenses earlier this year. 70% of the fund is reserved for the government’s gigabit ambitions and 30% should be spent on the “digital pact for schools”. Looking at the pace and scope of the broadband rollout so far, it must be questioned whether the government’s timeline to build a “converged gigabit-ready infrastructure” and to provide ubiquitous 5G connectivity by 2025 can be met.

The government’s strategy for “AI made in Germany” announced in 2018 aimed at an investment of around EUR 3 bn in AI until 2025 (i.e. ~ EUR 500 m p.a.). This could be a good starting point even though – accounting for just ~0.15% of the overall budget – it can hardly be called ambitious. And it is dwarfed compared to the US, where public spending on non-defence AI research alone should reach USD 1 bn in 2020, and China, for which AI R&D spending is estimated between 1.7 and 5.7 USD bn in 2018, according to CSET.⁴ On top of that, the German AI budget was slashed this year to only EUR 1 bn until 2023 against a more constrained fiscal outlook.

⁴ <https://cset.georgetown.edu/wp-content/uploads/Chinese-Public-AI-RD-Spending-Provisional-Findings-2.pdf>



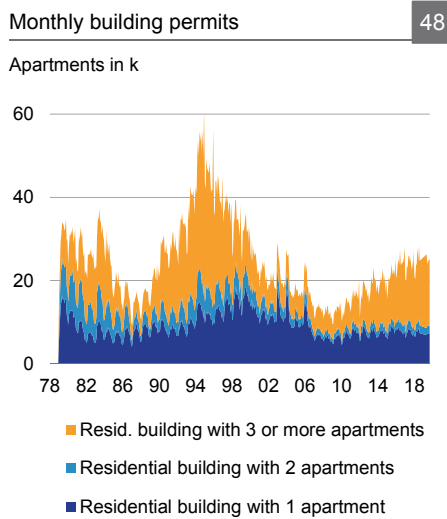
The two examples illustrate what can be seen as a common thread in the German response to the technological challenges over the past years: thinking big and acting small.

The visible pressure of the digital transformation on Germany's economy might still be too low to enforce a serious rethink of this approach. But the risks of responding too slowly or too little cannot be ignored any longer, in particular regarding sectors where Germany is still well positioned (robotics and automation, industry 4.0, networked mobility etc.). The delusion that sufficient time will be left to later compensate for current shortcomings and delays is a dangerous one.

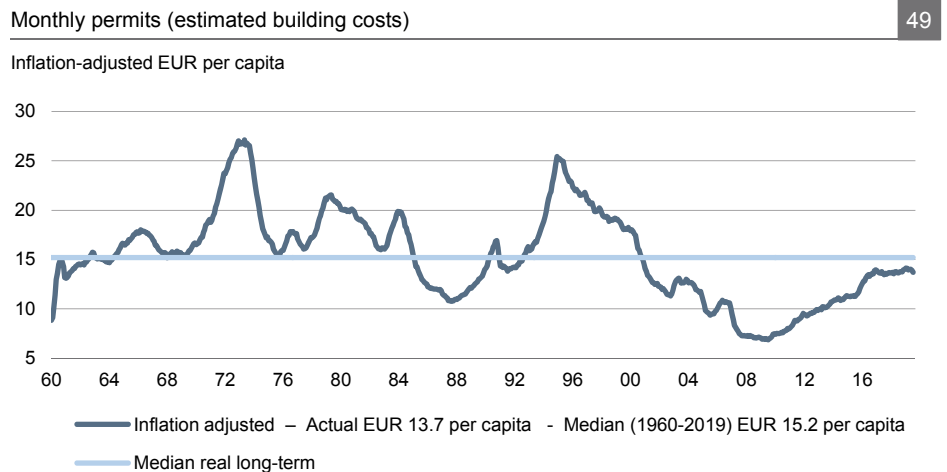
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Housing market: Boom unlikely to end soon ...

Housing market fundamentals look set to remain more or less intact in 2020. Supported by robust income growth and the solid labour market, demand for housing continues to be high. Moreover, we expect immigration – despite weaker data during the summer – to decline only moderately in the years ahead, whereas new housing supply will likely be limited for a multi-year period, given the lack of skilled workers across the entire building sector and many additional regulatory and political obstacles. Another factor arguing against sharply increasing supply is the rising number of political interventions in the housing market. Building permits, as a consequence, have stagnated in 2019 and even point to the downside for residential buildings with three apartments and more. Furthermore, there is some anecdotal evidence to suggest that developer activity in the metropolitan areas and some large cities is declining. Following contractions in the preceding years, in 2019 permits may have suffered further, particularly in densely populated cities.



Sources: Deutsche Bank Research, Federal Statistical Office



Sources: Deutsche Bundesbank, Deutsche Bank Research

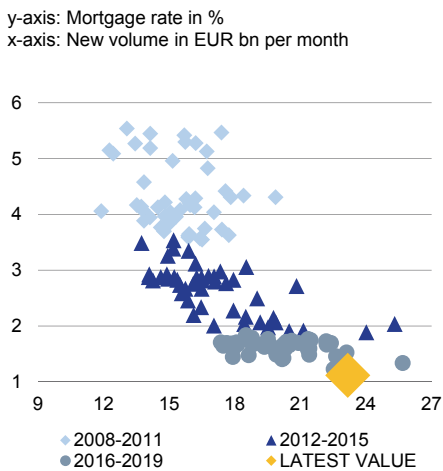
...despite or possibly because of the wave of regulation

A key driver is the "socialist" housing policy of the City of Berlin and its announcement of a five-year rent price cap from 1 January 2020. With the ruling in the envisaged judicial review proceedings against the rent price cap likely forthcoming in the second half of the year, the housing sector will probably keep a keen eye on Berlin in 2020. How the court will decide is a controversial issue among lawyers. It hence remains to be seen whether the existing bill is approved, adjusted or declared null and void. In the latter half of the year, Berlin may also hold a referendum on expropriating large landlords with more than 3,000 apartments. Although the referendum is not legally binding, it would add



Fragile – handle with care

New mortgages 50



Sources: Deutsche Bundesbank, Deutsche Bank Research, ECB

German residential property: Prices and rents 51



Sources: riwis, Deutsche Bank Research

to political pressure, if adopted, particularly in view of the election of the Berlin Senate in autumn 2021. Triggered by the Berlin initiatives, tendencies towards more comprehensive market interventions can also be seen elsewhere in Germany, sparking massive unrest among investors and in the construction industry with respect to Germany as a whole. The existing shortage of housing is hence cemented or even aggravated. It would be a positive step if new construction were promoted as vigorously as socialist measures. Along with being the best safeguard against a house price bubble and macroprudential risks, only vacancies help to ensure market normalisation and prevent further divisions in society.

Credit cycle started: Up 10% on the previous year

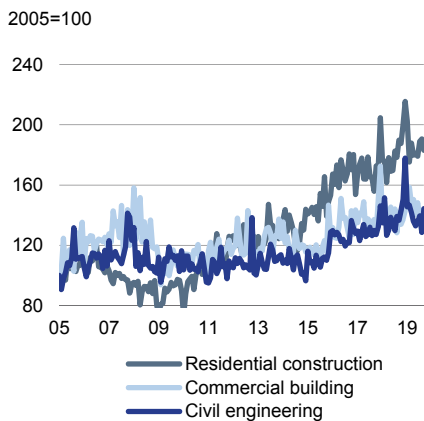
From an economic perspective, housing policy seems even more ambivalent if credit growth gathers momentum. In 2019, the mortgage loan book of all banks expanded at a double-digit rate for the first time since 2009. The rapid expansion of credit pushed house prices up sharply this year, and credit-driven price impulses are likely to persist in the housing market in 2020, as the ECB looks set to maintain its zero interest rate policy over the next few years. Should credit dynamics remain at high levels in the years beyond, the risk of a house price bubble increases and with it that of regulatory interventions by the Financial Stability Committee (FSC). Enabling the countercyclical capital buffer in spring 2019, the Committee has to date implemented only minimal measures that are little more than symbolic gestures. In the face of current strong credit dynamics, however, political pressure to take further measures is likely to increase. But tightening regulations – such as a cap on mortgage lending value or additional capital requirements – would limit overall lending. Macroprudential measures, like socialist housing policy, have an ambivalent impact. They have a negative effect on new construction and, as a consequence, cement the existing supply shortages in the housing market. Nor does the FSC have the information it needs to regulate the housing market in a target-oriented manner. Whether mortgage loans in Germany are used to finance a new building or to buy an existing home is not captured in a survey. And this is unlikely to change, even though data from one of the most comprehensive statistical collections, the AnaCredit statistics – a multi-year project of European central banks – is due to be released from year-end 2020. In recent years, the leverage of banks when financing property has increased (see Financial Stability Report of the Bundesbank). Now, higher private household debt could temporarily push up house prices, which would boost the risk of sharp setbacks – though it may be many years before we see this happen – and, as a result, negative equity.

Rents and prices for houses and apartments picked up in 2019

Given low supply, prices continued to rise in 2019. According to bulwiengesa (126 cities), house prices and apartment prices rose 6.3% on average. As in the preceding years, the strongest price increases were registered in metropolitan areas and large cities. However, many smaller cities also experienced significant price rises, and in only 3 of the 126 cities did prices decline. The price boom has an impact on rents, too. In 2019, rents for newly completed and existing homes rose by c. 3 ½% and 2 ½%, respectively. The momentum in rental growth declined again. Here the uncertainty of the regulatory environment is taking its toll. For 2020, we expect the cycle to continue, with price and rental dynamics slowing only marginally.



2005-2019 New orders 52

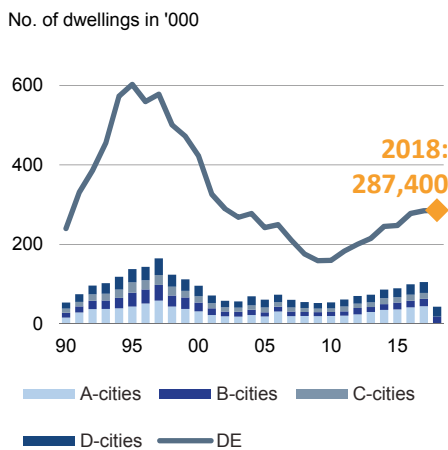


Sources: Deutsche Bank Research, Federal Statistical Office

Building investment: Slowing residential construction ...

Regulatory headwinds have unsettled the sector as a whole, as reflected by the ifo index for construction. Whilst the current assessment is still near its all-time highs of autumn 2018, companies are increasingly less confident with regard to their expectations for the next six months ahead. Currently, they are neutral. As the construction industry's assessment of the business situation has been far too pessimistic throughout the entire cycle since 2009, we interpret this index trend as a continuation of the fairly sluggish investment growth that characterised the whole building sector over the past years. For residential construction, on the other hand, we expect a slowdown, not least due to lackluster order intake in 2019. Following 4% yoy in 2019, a slight decline to below 3% seems likely for 2020. The loss of dynamics is also reflected in building permits. Against this backdrop, the number of completed apartments should come to under or close to 300,000 in 2019 and beyond, well below annual demand. Supply shortages will hence dominate the housing market in the years to come. We therefore stick to our view of recent years that "the cycle looks set to continue until 2022 or beyond". In summer 2019, however, net migration slowed to an all-time low since 2010. For now, we believe this phenomenon to be only temporary, as labour demand in industry has weakened. If this trend continues, however, the cycle might end sooner than we currently expect.

1990-2018 Completions 53



Sources: riwis, Federal Statistical Office, Deutsche Bank Research

... whereas shortages in office space should stimulate commercial construction

In the face of regulatory uncertainty, particularly in residential construction, investment will likely be shifted to commercial construction, pushing up activity in this sector. In 2019, order intake remained on a sharp uptrend. Moreover, employment growth in the services sector and extraordinarily low office vacancy rates in some cities argue for buoyant building activity. Following a rise of c. 2 ½% in 2019, we expect investment in commercial construction to accelerate to 3 ½% in 2020. Civil engineering activity reflects the investment barriers in the public sector. Despite strong annual growth of roughly 6% in 2019, capacity bottlenecks and declining order intake in 2019 – in the civil engineering sector and in roadworks – point to a slowdown. For 2020, we therefore expect growth of c. 5%. This would push total building investment up by just over 3% in 2020, after around 4% in 2019. As the political and regulatory measures that are currently being discussed will not do away with tight supply but may – as described above – aggravate shortages, putting an end to the house price cycle is probably doomed to fail. Irrespective of the looming ruling in the judicial review proceedings surrounding the rent price cap, regulatory uncertainty is likely to subside in 2021. In our base scenario, we expect investment in residential construction as well as total investment to expand by over 4% – even though the likelihood of worst-case scenarios has increased.

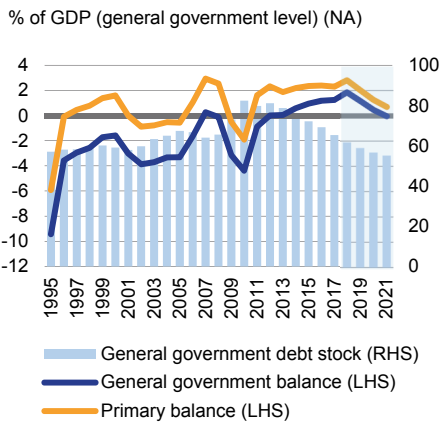
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Fiscal outlook 2020/21: Surpluses to vanish, but debt ratio remains on downward trend

54



Sources: WEFA, Federal Statistical Office, Eurostat, Deutsche Bank Research

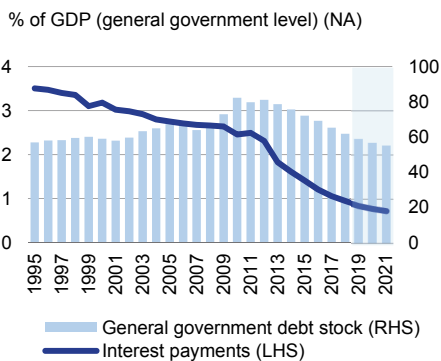
Fiscal surpluses to vanish by 2021 – public investment rising briskly, but increasingly constrained by supply-side bottlenecks

Government to post a lower, though still sizable financial surplus in 2019

Notwithstanding the strong cyclical headwinds in the domestic economy and the federal government's continuous expansionary policy agenda, Germany's consolidated general government sector – comprising the federal government, the federal states, local authorities and the social security system (pension, health, unemployment, care) – will again post a sizeable surplus in 2019, possibly amounting to more than EUR 40 bn (equivalent to c. 1.2% of GDP). That said, the government surplus will already be much lower than in 2018, when it reached a post-reunification record high of around EUR 62 bn (or 1.9% of GDP) (see chart 54).

Government interest payments are set fall further in 2020/21

55



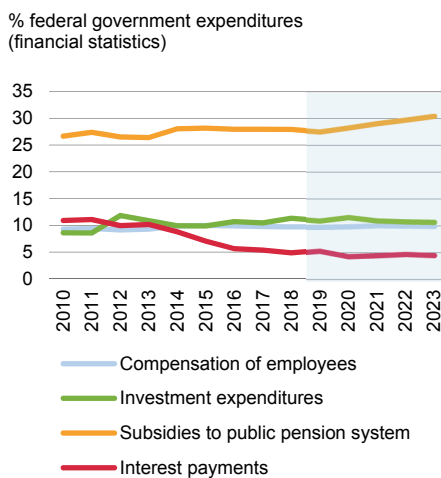
Sources: WEFA, Federal Statistical Office, Eurostat, Deutsche Bank Research

Higher social spending weighs on sustainability of public finances

A weak point of the 2020 budget and the current financial plan until 2023 is that the federal government is diverting an ever larger share into social spending in particular the public pension system. This is problematic as social spending is not lifting Germany's growth potential but is harmful to the former as it is financed through already high social security contributions and taxes (Germany's tax ratio stood in 2018 at an all-time re-unification high (see chart 61). While total federal government spending is set to grow on average at a modest 1.2% p.a. over the 2020-23 period, social spending will rise at the same time by 2.8%. At an average annual growth rate of 3.8%, federal government subsidies to the public pension system will grow even more strongly and finally exceed the EUR 100 bn threshold in 2020 (and by then accounting for c. 28.3% of total federal spending). The share of social spending will increase from around 50% in 2019 to 53.4% by 2023 (see charts 56 and 60).

Outlook for the federal budget based on the financial plan to 2023

56

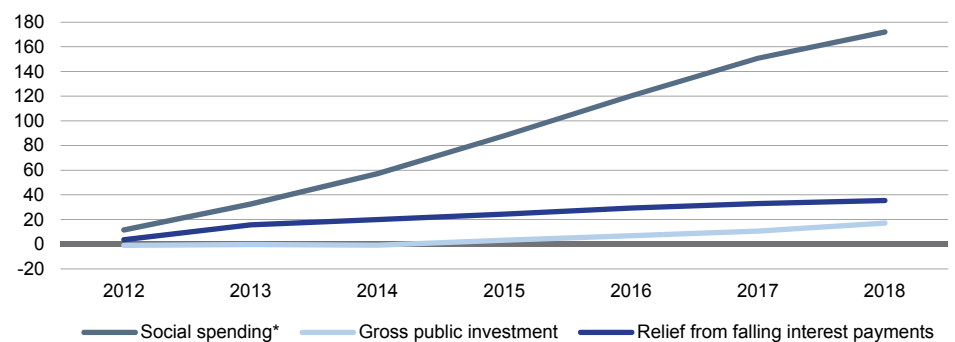


Sources: Federal Ministry of Finance, Deutsche Bank Research

Social spending has outpaced public investment

57

Change vs. 2011 in EUR bn, gen. government sector (national accounts data)



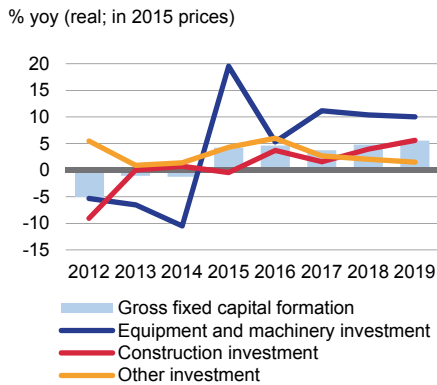
* Social monetary benefits and social benefits in kind

Sources: Federal Statistical Office, Deutsche Bank Research



Fragile – handle with care

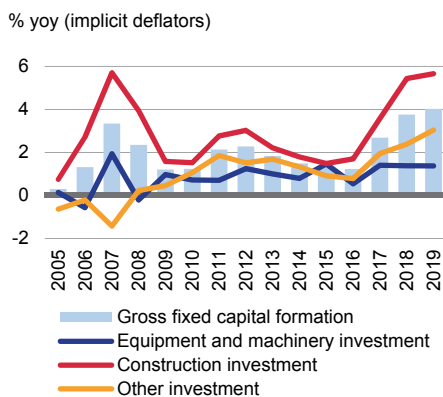
Public investment is rising briskly 58



2019: Q3 2019 vs. Q3 2018 on the basis of moving annual sums

Sources: Federal Statistical Office

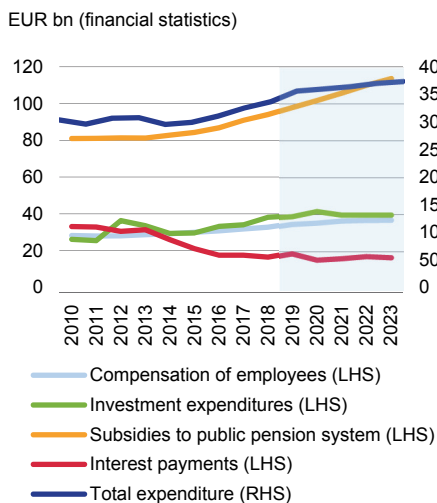
Prices for public construction investment have been on the rise 59



2019: Q3 2019 vs. Q3 2018 on the basis of moving annual sums

Sources: Federal Statistical Office

Outlook for the federal budget based on the financial plan to 2023 60



Sources: Federal Ministry of Finance, Deutsche Bank Research

With regard to the medium-term sustainability of public finances – and in view of the considerable demographic challenges that will put a larger burden on German public finances from the mid-2020s – the further substantial increase in statutory pension expenditures (e.g. pensions for mothers) and other pension promises beyond that are especially problematic. Admittedly, the key promise of the federal government, the "double stop line" (contribution rate for the statutory pension system does not exceed 20%, pension benefit level does not fall below 48% until 2025) will not yet weigh considerably on the federal budget – at least in the current legislative period. But starting in 2025 (when the current pension programme of the government expires), considerable adjustments may be required (e.g. withdrawal of current promises, more rapidly rising federal transfer payments to the pension scheme and/or an increase in retirement age).

In terms of fiscal policy priorities, not much will actually change in the years to come. Rather than using the still-large fiscal coffers for more meaningful tax cuts and/or reductions in high social security contributions to boost potential growth, the lion's share is diverted to even higher social spending or new costly social goodies of partially disputable value.

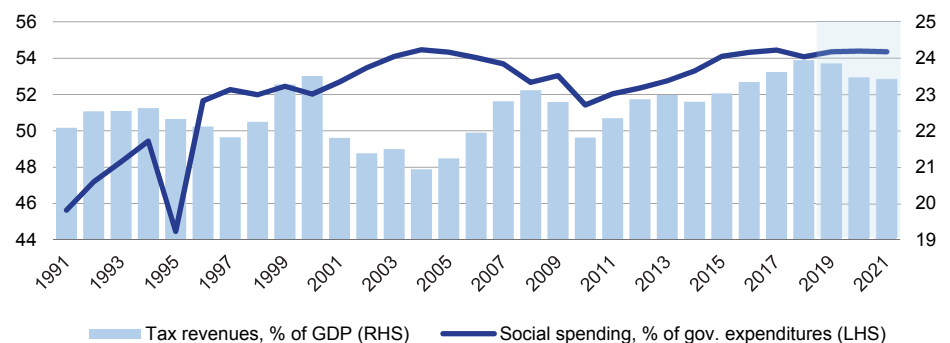
In this context, it is worth noting that social spending has clearly outpaced other spending items (such as public investment) since 2011. Moreover, it seems that the large cumulative savings from falling public interest payments were mainly used to finance a growing public welfare state (see charts 57 and 64).

Investment is rising briskly but remains constrained by supply-side bottlenecks

The government has raised its investment expenditures substantially already, but this has not silenced calls to raise public investment more strongly. Demand for public investment will likely remain high over the next decade given the need to renew large parts of the country's physical infrastructure (schools, roads, highways) and to expand the digital network.

Social spending is accounting for a rising share of spending, tax ratio remains very high 61

Social spending* and tax revenue of the general government sector (national accounts data)



* Social monetary benefits and social benefits in kind
Forecasts: ifo

Sources: Federal Statistical Office, ifo, Deutsche Bank Research

At the current juncture, it is not lack of finance that is preventing a stronger increase in (real) public investment. Instead implementation of public investment projects is being delayed by a series of supply-side bottlenecks. These bottlenecks relate to both capacity constraints and skills shortages in the construction sector as well as lack of administrative (i.e. planning) resources at (mainly) the municipal level (which carry out the bulk of public construction investment). According to the CDU's fiscal expert, Eckhardt Rehberg, more than EUR 20 bn

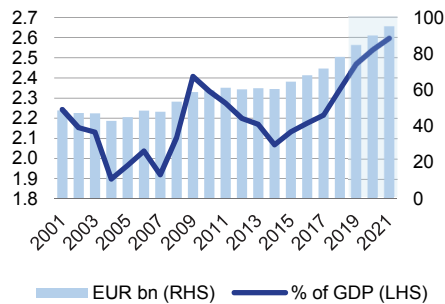


Fragile – handle with care

Public Investment spending has risen strongly in recent years

62

Gen. government sector (national accounts data)



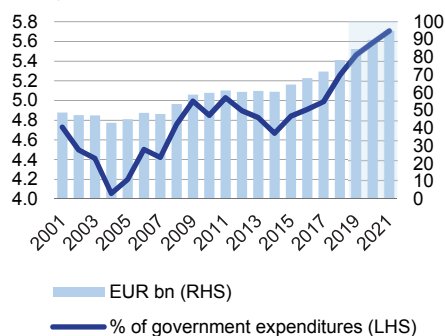
Forecasts: ifo

Sources: Federal Statistical Office, Deutsche Bank Research

Public Investment spending has risen as a share of total public spending

63

Gen. government sector (national accounts data)



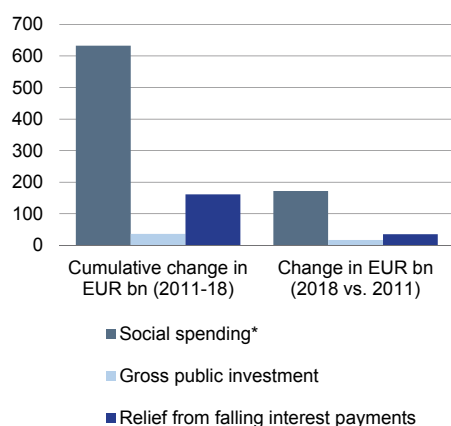
Forecasts: ifo

Sources: Federal Statistical Office, Deutsche Bank Research

Social spending and (gross) public investment in the context of falling interest payments

64

Change 2018 vs. 2011 in EUR bn
Gen. government sector (national accounts data)



* Social monetary benefits and social benefits in kind

Sources: Federal Statistical Office, Deutsche Bank Research

that were budgeted for public investment projects are ready to be withdrawn and spent (see FAZ from 8th September 2019). Furthermore, there is anecdotal evidence that red tape and resistance by citizens to investment projects (e.g. towards wind power plants) are further complicating the timely and effective implementation of public investment.

A look at Q3 2019 national accounts data shows that public investment is already expanding briskly. In Q3 2019 public investments increased by a high 9.7% yoy in nominal terms (compared to Q3 2018 on the basis of rolling annual sums) (2018: 8.7% yoy). Among subcomponents, capital expenditures surged 11.5% yoy (11.9% yoy), while investment in construction expanded at 11.5% yoy (9.6% yoy). In 'real' (price-adjusted) terms total public investment expanded by a still-strong but much lower 5.5% yoy (thereof: capital expenditures at 10.0% yoy and construction at 5.6%). The exceptionally large increase in the deflator for public investment, most notably in public construction investment (+5.7% yoy), is a clear indication of supply-side constraints (high capacity utilisation, skill shortages), key impediments to higher (real) investment at present (see charts 58 and 59).

All of the above structural impediments to higher investment cannot be overcome overnight – thus, the calls for even more public investment spending are ill-founded. More public (infrastructure) investment spending will not lead to more construction – i.e. improve the country's physical infrastructure – but only drive construction prices even higher. Therefore, it is the government's task to set clear spending priorities and work towards a gradual (not abrupt) increase in public investment – something it seems to be doing. At the same time, the government should implement policy measures that mitigate the adverse effects of the skill shortage (e.g. improved education), increase its own administrative capacity where needed and reduce unnecessary red tape.

Budget surplus to vanish by 2021 amid weak growth and expansionary policies

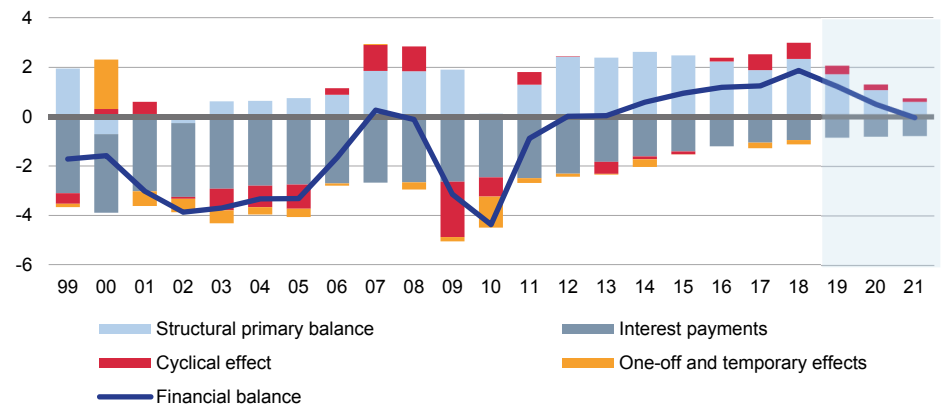
Overall, the environment for public finances remains mixed over the next two years. While the government will continue to benefit from ever-falling interest payments (due to very low or even negative yields on Bunds in light of ultra-expansionary monetary policies), government revenue growth should slow due to almost-stalling growth. Given both the further considerable rise in primary government spending (social expenditures, public investment) and moderate tax relief (e.g. cold progression allowances, partial abolishment of the solidarity surcharge starting in 2021), the general government budget position should weaken rapidly in structural terms – as reflected in a projected deterioration in Germany's structural primary budget balance of around 0.6 percentage points of GDP next year and a further 0.5 pp in 2021 (see chart 65). Overall, we expect the general government's financial surplus to narrow sharply to just ½% of GDP in 2020 and to vanish in 2021. This notwithstanding and thanks to a negative interest rate / GDP growth differential, Germany's general government debt ratio should continue to trend lower, undershooting 60% in 2019 and falling further to 56.9% in 2020 and 55.3% in 2021 (see charts 54 and 55).



The still large government budget surplus is set to vanish by 2021

65

% of GDP (general government sector - national accounts data)

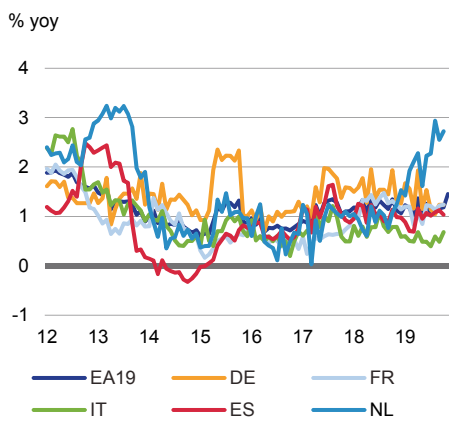


Sources: Federal Statistical Office, AMECO, OECD, Federal Ministry of Finance, Deutsche Bank Research

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Euro area: HICP excl. energy and unprocessed food

66



Sources: Eurostat, Haver Analytics, Deutsche Bank Research

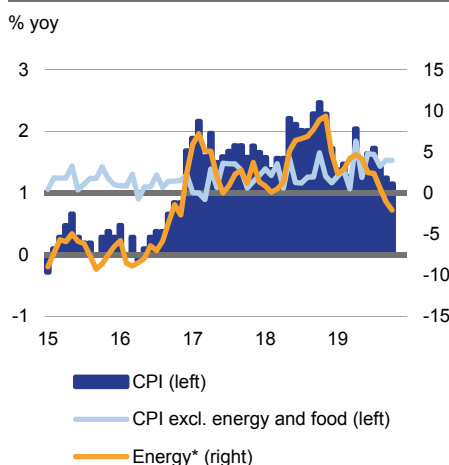
Inflation to decline towards 1% amid weak growth and lower energy prices

Inflation remained extraordinarily moderate in 2019

Inflation – as measured by the consumer price index – has remained tepid in most mature economies this year. In the euro area, inflation rates have differed strongly in the five largest economies. In Germany (1.1%) and France (1.2%), annualised rates based on the harmonised index of consumer prices (HICP) were slightly higher than on average in the euro area (1.0%) in November 2019, whereas inflation in Italy and Spain continued to be particularly subdued, at 0.4% and 0.5%, respectively. The only exception was the Netherlands, where inflation in November came in at 2.6%, well above the ECB's inflation target. The clear inflation difference relative to the other countries, however, was largely caused by an increase in the VAT rate at the beginning of the year. With the exception of the Netherlands, core inflation dynamics in the EMU remained weak, with the most recent rates of 1.2% in Germany and France and only 0.7% and 1.0% in Italy and Spain, respectively (see chart 66).

Core inflation has fallen again

67



* Household energy and fuels

Sources: Destatis, Deutsche Bank Research

Dichotomy in core inflation: Goods point to the downside, services to the upside (for now)

Aggregate German core inflation rates, i.e. consumer prices excluding volatile energy and food prices, hardly moved upwards this year – despite the still relatively robust labour market and buoyant domestic demand/services activity (see chart 67). When looking more closely at core inflation, however, we can see that the rate of goods (industrial goods ex energy) seems to have decoupled from the services rate (ex health) of late. Whilst the core services rate continues to edge up (to over 2%; on the basis of the HICP), core inflation of industrial goods slipped sharply (to under 1% currently) (see chart 69). This dichotomy can be easily explained by the chasm that runs through the German economy, with industry still stuck in a persistent recession, whereas the performance of services-oriented domestic activity is presently relatively sound.

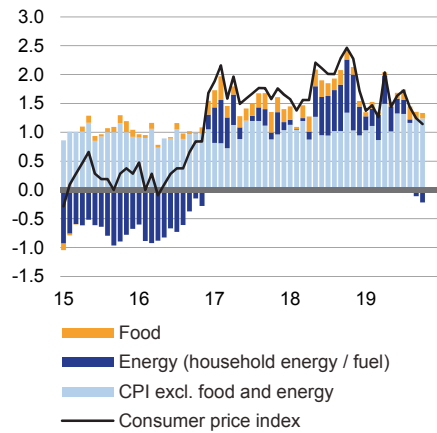


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Higher energy and food prices lifted the inflation rate upwards in 2017

68

% yoy and growth contribution (pp)



Sources: Federal Statistical Office, Deutsche Bank Research

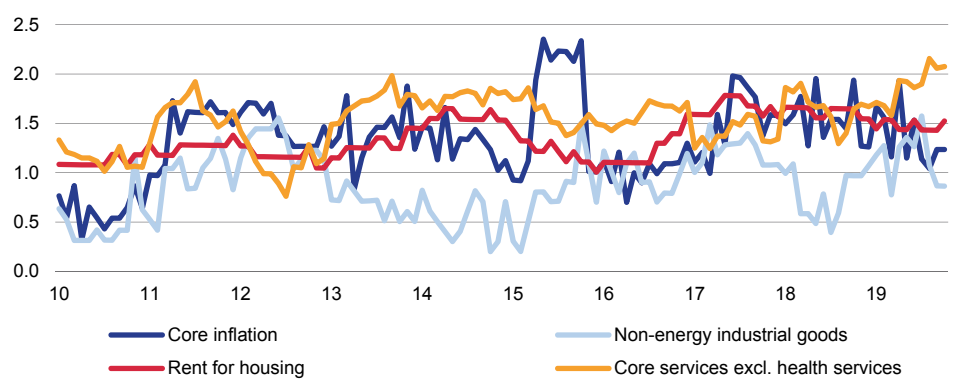
Inflation rate pushed lower by declining energy prices

Recently, energy prices have been putting strong downward pressure on German inflation dynamics (see charts 67 and 68), partly because crude oil has traded lower. In Germany, annualised energy inflation (household energy and fuels) as defined by the national consumer price index (CPI) plunged to -2.1% in October (down from +4.6% in April 2019) (see chart 67).

DE: Overall no big movements in core inflation, though core services inflation has risen

69

HICP, % yoy

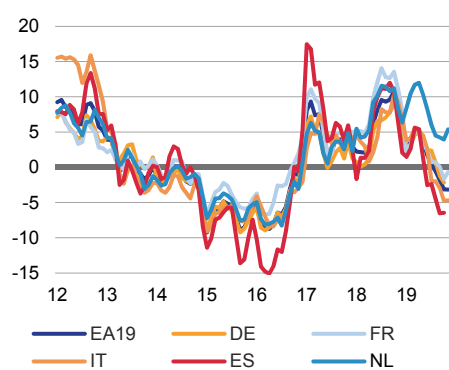


Sources: Eurostat, Deutsche Bank Research

Euro area: HICP energy

70

% yoy



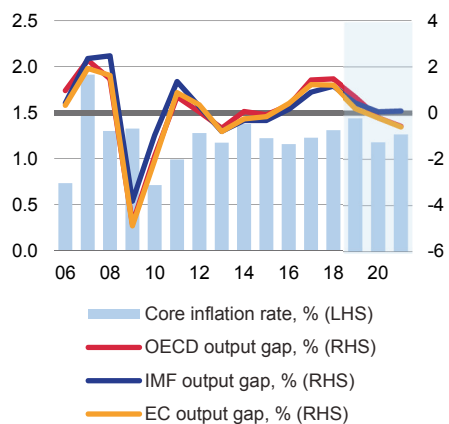
Sources: Eurostat, Haver Analytics, Deutsche Bank Research

For the year ahead, weak oil demand (global industrial recession, lackluster propensity to invest, slowing global trade), together with a structural oversupply, argues against higher oil prices. Based on our estimates, the price of a barrel of oil (Brent) looks set to drop from around USD 65 this year to on average USD 54 in 2020.

In combination with a slightly stronger euro, oil prices calculated in euro – the relevant measure for the energy component of German inflation – might plummet from just under EUR 57 per barrel to only EUR 47. For 2021, we assume an uptick to roughly USD 62 per year. In the euro calculation, however, the increase would be far more subdued, given the expected appreciation in EUR.

Rising capacity utilisation should lead to upward pressures on core inflation

71



Sources: OECD, IMF, EC, Destatis, Deutsche Bank Research

Core inflation to reach its peak in 2019

In the face of the structural problems and the slackening trend in Germany's export-driven key industries (automotive, mechanical engineering, chemicals) as well as current economic uncertainties, we expect wages per employee – an important leading indicator for core inflation – to rise at a much slower rate in 2020/21 than it did this year. In our view, wage growth of only c. 2.5% per annum ought to be in sight, following an expected 3.2% in 2019 (2017/18: 2.5% each) (see chart 72). Moreover, capacity utilisation in German industry looks set to remain on the decline, and the (positive) aggregate output gap is likely to close further or might even turn negative (see chart 71).

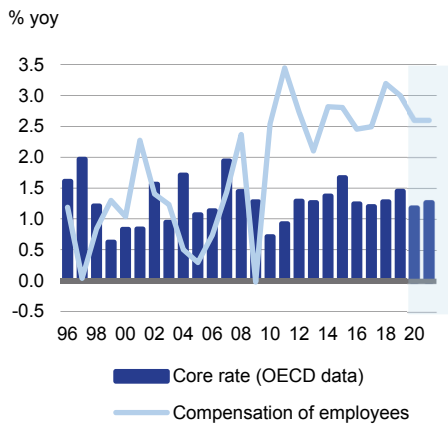
The to-date strong performance of (services-oriented) domestic demand should slow as the recession in industry drags on, which in turn should leave its mark on core services inflation – albeit with a time lag. Until industry is back on a sustainable growth path, industrial goods core inflation will likely remain subdued. German core inflation therefore looks set to reach its peak at 1.4% in 2019. For 2020, we expect a decline to only 1.2% (annual average), followed by a modest uptick to 1.3% in 2021.



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Core inflation vs. compensation of employees

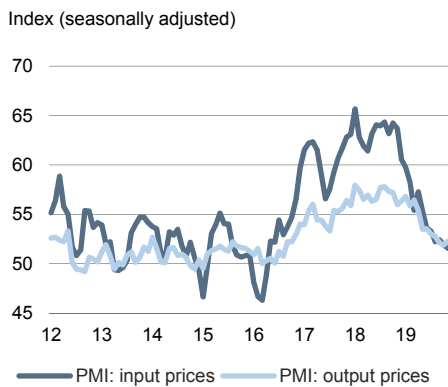
72



Sources: OECD, Deutsche Bundesbank, Deutsche Bank Research

PMIs indicate increasing price pressures

73



Sources: IHS Markit, Deutsche Bank Research

Headline inflation falling to 1% in 2020

Headline inflation peaked in 2018 at 1.7% (see chart 74) and looks to have fallen to around 1.4% this year. Given the expected decline in the core inflation rate and negative energy price inflation, a further decline in 2020 should occur, which would send the headline rate down to only 1.0% (CPI) [resp. 1.2% (HICP)]. By itself, the contribution of energy prices to headline inflation should reduce the national rate by around one-tenth of a percentage point (see chart 74). In 2021, the CPI might rise to 1.4%, thanks to moderate acceleration in core inflation and higher energy prices (HICP: 1.3%).

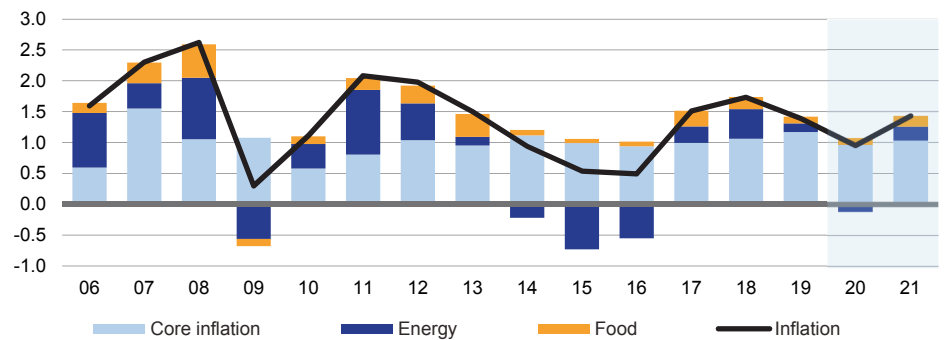
On balance, inflation should remain subdued over the next two years. Even rental prices are likely to remain under control, despite the booming housing market and the increasing shortage of residential space (October 2019: +1.4% yoy based on the CPI and +1.5% based on the HICP) (see chart 69).

Current leading indicators such as the subcomponents of the purchasing mngers' survey on input and output prices point to sharply declining price pressure, with readings of just over 50 (the index value marking the threshold between increasing and decreasing prices) arguing for only moderate price inflation (see chart 73).

Consumer price inflation outlook for 2019/20

74

Contributions to annual (average) inflation rate, percentage points



Sources: Destatis, Deutsche Bank Research

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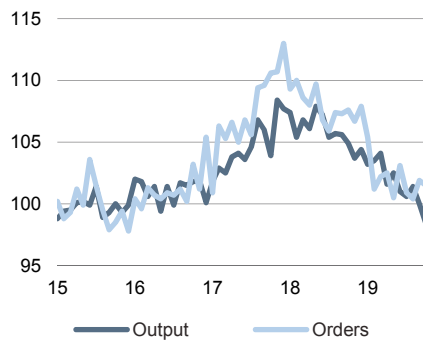


German industry: Momentum to remain sluggish again in 2020 – risk of structural weakness is increasing

Industrial recession not over yet

75

Manufacturing industry in DE, 2015=100



Source: Federal Statistical Office

German manufacturing output looks set to decline by c. 4% in real terms in 2019. This is the first decrease in output since 2013 and the strongest since 2009. Back then, German industrial output shrank by more than 17% due to the global economic and financial crisis. The manufacturing recession began in Q3 2018 and should continue until end-2019. Even in 2008/09, German industrial production declined only for four quarters in a row (and remained stagnant for another quarter).

There are several reasons for this long industrial recession, some of which will remain in place in 2020. The first is obviously the weakness in global trade with goods. Indeed, trade decreased slightly in 2019, and trade growth should remain moderate in 2020, at 2.5% in real terms. The persistent trade conflicts, in particular between the US and China, have dampened trade activity for some time now. In addition, the increase in uncertainty is weighing on the global propensity to invest.

The trade dispute between the US and China is not the only problem; the US has been threatening for months now that it may introduce tariffs on auto imports from the EU, and that controversy is not over yet. While the original deadline of mid-November 2019 went by without a clear statement by the US government, this does not mean that the matter is closed.

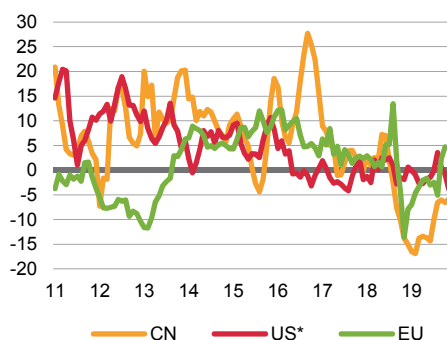
German industry is heavily focused on capital goods exports and is therefore suffering particularly from the weakness in world trade and the overall reluctance to invest in machinery and equipment.

Cyclical and structural challenges in the auto industry weighing on aggregate industrial output

Quite weak car demand in all three major markets

76

New passenger car registrations/sales, % yoy, 3M mov. avg.



* Light vehicles

Sources: ACEA, BEA, CAAM

German industrial output has also been dampened by the weak momentum in Germany's automotive industry. The auto industry is the biggest industrial sector in terms of sales and gross value added; in 2017, its share in aggregate value added in manufacturing amounted to almost 21%. Moreover, it is often the most important domestic customer of other industrial sectors. The auto industry was and is faced with a number of challenges that had an impact on domestic production in 2019 and will partly continue to make themselves felt in 2020.

- At the end of 2018, the shift to the new WLTP emissions test standard disrupted the sector. Several models were temporarily not available, which caused both new registrations and domestic output to decrease considerably towards the end of the year. The negative impact from the WLTP shift continued into 2019.
- The WLTP effect gradually petered out during 2019, only to be replaced by general weakness in demand, which is still visible in all three major car markets (although the reasons are different). In particular, car sales in China fell much more strongly than expected in 2019. The trade conflict between the US and China led to higher import tariffs on cars produced in the US and weighed on consumer confidence. In addition, tax incentives supported Chinese car sales until mid-2018 and made consumers bring forward their planned car purchases. In response, car sales in China fell at a two-digit rate in 2019. Overall, global car sales shrank for the second year in a row in 2019. We expect the global car cycle to recover slightly in 2020, with uncertainties to this forecast stemming mainly from the economic and political

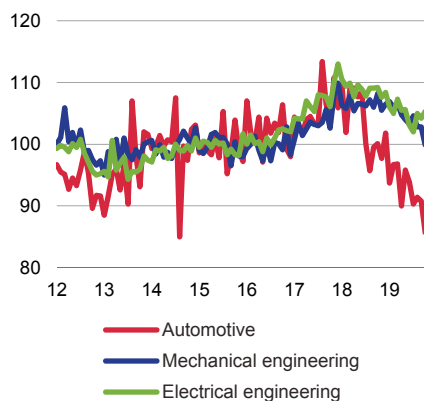


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Decline in output particularly strong in the automotive industry

77

Output in selected sectors in DE, 2015=100

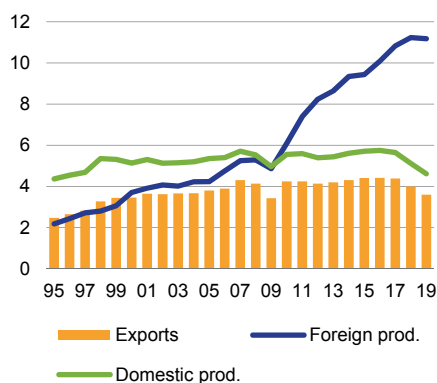


Source: Federal Statistical Office

German automotive industry becomes more international

78

Passenger car production by German OEMs and car exports from Germany, m



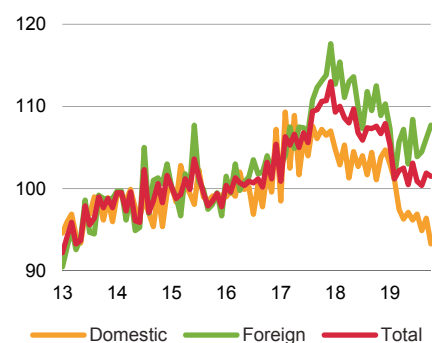
2019: Forecast

Source: VDA

Divergent development of late

79

Manufacturing industry in DE, orders, 2015=100



Source: Federal Statistical Office

framework conditions in China. After almost two years of declining sales, there is probably some pent-up demand in China, which may prop the market up in 2020. Our local research colleagues have explained this in more detail in their latest outlook for China. If the government introduces incentives for car purchases, the Chinese market might even surprise to the upside in 2020. In turn, German industrial output should benefit, even though a large share of Chinese demand for cars is met by local factories.

- Domestic car production also suffered from the fact that the lifecycles of several important car models produced in Germany ended in 2019. As a rule, demand for car models declines towards the end of their model lifecycles because customers tend to wait for their successors. That is why German carmakers were able to maintain or even extend their market shares in many markets despite domestic output falling considerably. German producers kept their output abroad relatively stable. This one-off effect will run out in 2020 once the German factories start to build important models. Overall output should benefit from the ramp-up of production.
- And finally, some production capacities were not available in 2019 because several factories are being refurbished for electric car production. The structural shift towards e-mobility and global demand weakness are key reasons for cost-cutting programmes at many German carmakers and suppliers, to be continued in 2020. Component suppliers in particular are cautious about their near-term production plans.

Output of other capital goods contracted as well

Overall, automotive production was probably down 10% in real terms in 2019 – the second decline in a row (2018: -1.7%) and the strongest since 2009 (-21.7%). Contrary to expectations, output was still down in year-on-year terms towards the end of the year, even though the basis had already been dampened by the WLTP effect in 2018. This was caused by the global weakness in car demand and the one-off effects mentioned above. Output in the automotive industry shrank more strongly than in other capital goods sectors, such as mechanical engineering (2019: c. -3% in real terms) or electrical engineering (-4%). Production in the chemicals and metals sectors probably declined 3-4% in real terms in 2019. Overall, all major industrial sectors contracted in 2019. The food sector, which is less cyclical, was the only sector that likely registered a small increase in output.

The bottom is in sight, but the recovery in 2020 will likely be slow

Manufacturing orders have been mixed over the last few months. While foreign orders stabilised during 2019 and even rose in the last few months, domestic orders have been trending downwards.

Business expectations in manufacturing have been negative since December 2018. However, the downtrend has not continued in the most recent surveys, which suggests that the situation is at least not deteriorating further. While a small majority of industrial companies are still optimistic about their current situation, their number has declined significantly from the highs seen around the turn of the year 2017/2018. The deterioration in capacity utilisation also continued until the beginning of Q4 2019 at least. While capacity utilisation is currently just below the long-term average, it is still c. 12pp above the level seen in mid-2009. This means that the current underutilisation is small in historical context, and most companies should be able to handle it.

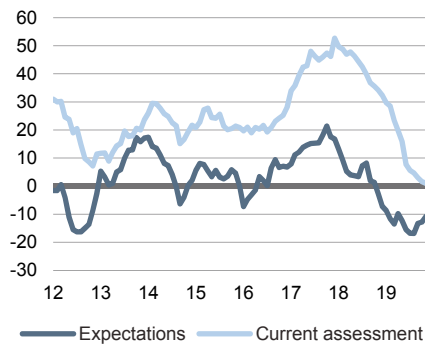


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Turnaround in business expectations

80

Manufacturing industry in DE, balance of positive and negative company reports

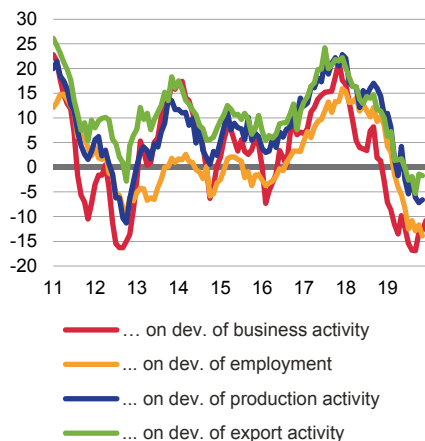


Source: ifo Institute

Expectations in the German industry still in negative territory

81

Company expectations, balance of positive and negative company reports

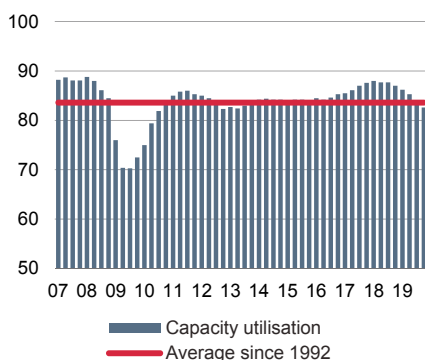


Source: ifo Institute

Capacity utilisation still on the decline

82

Capacity utilisation in the manufacturing industry in Germany, %



Source: ifo Institute

Some companies may find that the cyclical slowdown provides a welcome opportunity to improve internal procedures, particularly since such efforts may have fallen by the wayside in the last few years due to the good order situation and the search for qualified labour. According to the latest survey by the German Chambers of Commerce and Industry (DIHK), export-oriented industrial companies no longer regard the lack of qualified labour as the most important business risk for the first time since autumn 2016. Instead, they mentioned cyclical factors, such as domestic and foreign demand, and the economic framework conditions.

Output to decline again in 2020

All in all, these indicators suggest that German industry is moving towards the bottom of the cycle and might reach it at the beginning of 2020. However, this is true only if the trade conflicts abate as expected.

So are things looking up in 2020? Not at all. As explained in our chapter on German exports, global trade, including German exports, is likely to grow more strongly in 2020 than in 2019, which was a weak year. Still, the momentum is limited. We therefore expect only a moderate pick-up in output growth in 2020. Due to the significant statistical underhang around the turn of the year 2019/20, the uptrend will not be sufficient to result in a rise in aggregate production for the year as a whole. Indeed, we expect manufacturing output to decline 1.5% in real terms in 2020.

Most capital goods sectors (mechanical and electrical engineering) and their upstream sectors (e.g. metals and plastics industries) are likely to see output decline slightly or stagnate. The weakness in the chemicals sector will probably continue, particularly since it is increasingly due to structural reasons (shrinking capital stock in Germany). Following a significant decline in 2019, the automotive industry might see output rise slightly in 2020, provided that the global demand weakness abates (particularly in China) and that customers like the new models produced in Germany. The evolutionary shift towards e-mobility is likely to play a minor role for now. Still, to avoid fines for non-compliance with the carbon limits, producers will probably aim to sell more e-cars and are expected to cross-subsidise e-car sales.⁵

Risks in both directions

Over the last few quarters, we have regularly mentioned economic and geopolitical uncertainties as risk factors for our forecasts. Downside risks have predominated. And indeed, a further escalation of the trade conflict between the US and China remains the most important singular risk. However, there are some upside risks to our forecast for German industrial output, too. If the US and China or the US and the EU resolved their trade conflicts, the agreements might quickly stimulate global investment activity and thus prop up the business of German companies. In any case, we are likely to see some pent-up demand. We have already mentioned that a significant increase in Chinese car demand might support a stronger pick-up in industrial activity. It is quite possible that our outlook for the industry for 2020 is somewhat too pessimistic.

⁵ See Heymann, Eric (2019). E-mobility: Remaining a niche phenomenon for now – at least without subsidies. Deutsche Bank Research. Germany Monitor. Frankfurt am Main.

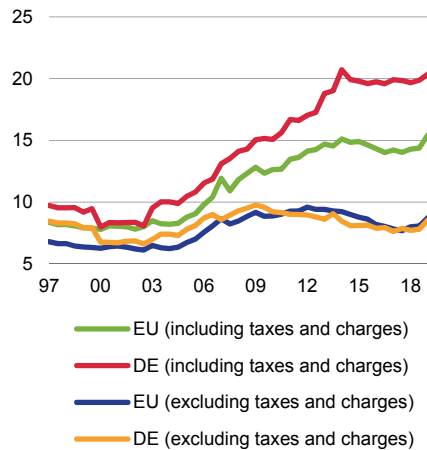


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Taxes and charges are the main drivers of electricity prices in Germany

83

Electricity price for industrial customers*, cents per kilowatt hour



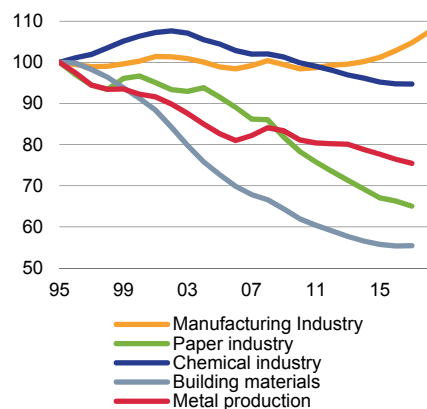
* Annual electricity consumption, between 500 and 2.000 MWh

Source: Eurostat

Real net fixed assets decline in energy-intensive sectors

84

Real net fixed assets in Germany, 1995=100



Source: Federal Statistical Office

Dangers to Germany's attractiveness as an industrial location

Regardless of the current cyclical developments, there is a risk that Germany will become less attractive as an industrial location in the long run. For example, costs as an industrial location in the long run. For example, costs have risen in the last few years. Labour costs and effective average corporate tax rates are among the highest in an international comparison, as are industrial electricity prices. Energy-intensive industries have been cautious about investing in Germany for years now because the long-term thrust of German and European climate and energy policies is unclear. Their domestic capital stock has been declining for some time.

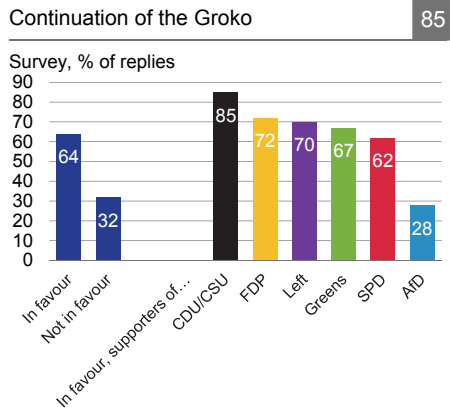
The auto industry may shift an even larger share of its investments in plants, machinery and equipment abroad to offset cost increases (for example, investments in alternative propulsion systems necessary to comply with carbon limits or higher labour costs). Many German carmakers have announced or already made investments in Hungary, the US or Mexico, and capacities in China look set to be expanded further as well. Related sectors will probably follow suit. During the last few years, foreign investments in the auto industry had not eaten into Germany's status as a car-producing country. In almost every year, more than 5 million units were built – a quite satisfactory number. In addition, better features in cars have led to considerable qualitative growth. In 2019, however, car output dropped well below 5 million units, and it will not be easy to push it above this threshold again.

In addition, the German workforce is likely to decline considerably in the long run, which is why some political decisions, such as reducing the retirement age to 63 or taking back measures that make the labour market more flexible, are counterproductive. In view of these structural difficulties and the likelihood that global trade growth looks set to remain moderate in 2021, we are cautious about industrial output in 2021 as well. We do not think the losses of 2018/19 will be offset by then. Political decisions will have a major impact on the attractiveness of Germany as an industrial location. After all, manufacturing remains a key driver of innovation and technical progress. But even the most innovative companies cannot be competitive if the country where they are located cannot keep up with international standards.

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German politics: Groko - quibbling but not quitting

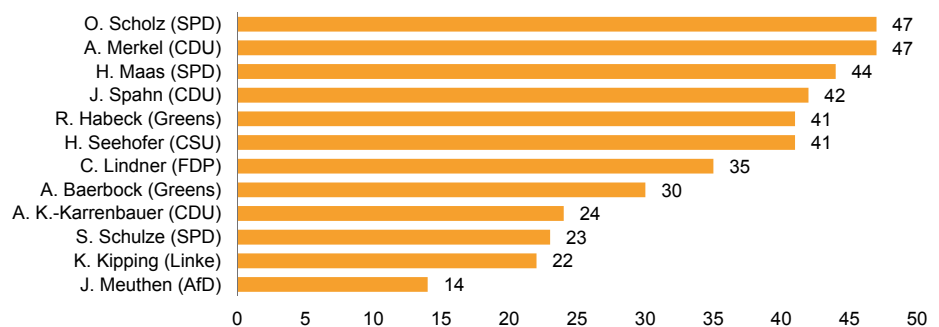


German politics has received attention beyond its borders throughout 2019 – less because of policy decisions, more with regard to the fortunes of Groko. This is not a surprise as Germany and Chancellor Merkel are still seen as a stability anchor in a European Union characterised by the unstable governments of other big EU partners such as Italy, Spain or UK and increased electoral uncertainty. The recent peak of interest in German politics was the election of new SPD leadership team and calls for adjustments in Groko's policy course in the second part of the term (see details below). But while we continue to consider the risk of an early break-up of the Groko rather low, with the German political landscape fundamentally reshaping, politics are unlikely to move toward quieter waters.

Federal election in 2021 casting its shadow. With the federal election in autumn 2021 already casting its shadow, the coalition parties have to walk the fine line of sharpening their respective profile and at the same time maintaining constructive cooperation to fulfill the electorates' mandate – a broad majority of Germans still wants to see Groko finish its term and opposes snap elections (DeutschlandTrend, ZDF Politbarometer). More importantly: Neither the CDU nor the SPD is as united a party as in the past and both need time to prepare for election campaigns. The CDU must reconcile the economically liberal wing with the more pragmatic wing that has supported Chancellor Merkel's policy course of the last years. The SPD, too, is split between the more leftist wing, which dominated the recent party convention and voted for the new leadership duo, and the more conservative, pragmatic wing that favours continuation of Groko. This environment will further fuel existing controversies between the coalition partners and produce significant political noise in Q1/ 2020 when agreement over the new political priorities needs to be reached and implementation of the climate package and the basis pension ensured.

Popularity ranking of important German politicians 86

Survey: "Are you very content/content with the political work of ... ?, % of total replies"



Difficult decisions about frontrunners for 2021 federal election. The implications of the – policy (and electoral poll) driven – splits within the parties extend to the question of whom to choose as candidate for chancellor in the next election campaign. Usually, the respective party leader has (informal) prerogative. But in the case of the CDU, party leader Annegret Kramp-Karrenbauer (AKK) is not uncontested in her party, to say the least, and rather unpopular among the public. Only 35% of CDU/CSU supporters believe that AKK will become frontrunner for the next election (ZDF Politbarometer, Nov 29). Other party seniors such as the PM of NRW, Armin Laschet or Friedrich Merz are considered possible contenders for the CDU chancellor candidacy. CSU party leader and Bavarian PM Markus Söder has scotched any speculation (for the time being) that he would



aspire to the position but emphasized that the CDU/CSU will nominate a joint candidate. Sentiment in the CDU is difficult to appraise, but the party will most likely gravitate towards a candidate who is open to and compatible with multiple coalition options after the election. With this in mind, the frontrunner might in the end be someone not yet on radar screens.

SPD: Two heads cause a headache. With regard to the SPD, this question is even more delicate. One reason is that the party just elected a new leadership duo. Saskia Esken and Norbert Walter-Borjans won over the team of Finance Minister Olaf Scholz and received a strong mandate for repositioning the SPD. Their expressed aim is to double the SPD's share of the vote to 30%, but 70% of Germans do not believe in the success of this ambition; even among SPD supporters, 46% are sceptical (DeutschlandTrend, Nov 5). Thus, it seems fair to say that not many party members are likely to consider either of this rather unknown and unexperienced duo ready to lead the SPD as chancellor candidate into the electoral campaign. Walter-Borjans even doubted in a public statement (WELT, Nov 6) that the SPD – given its poor polling around 15% – would need to nominate a candidate at all. Judged by general approval rates, FM Scholz might still be seen as a better candidate to lead the SPD into the 2021 elections, but the party is more than critical towards his role in Groko. Another name mentioned in the media is the current Minister for Family Affairs in Merkel's cabinet, Franziska Giffey. All in all, the internal positioning of candidates and some infighting of the parties' wings are likely to distract CDU/CSU and SPD from effective governing.

Green party kingmaker of the next government. The Greens are watching the internal problems of CDU/CSU and SPD from the sidelines while also sending strong signals that they are willing to assume responsibility in a federal (coalition) government further down the road. The two party leaders, Annalena Baerbock and Robert Habeck, have achieved approval rates not previously seen in the party's history. For the time being, they have managed to reconcile the ideologically fundamental positions among some of the Greens with the party's more pragmatic majority, preparing the ground for potential coalitions with the mainstream parties. They can build on the experience of (different) coalition governments in ten of the sixteen German states. Profiting from the popular topic of climate change and polling at around 20% for quite some time already, they aim to broaden their portfolio. But surveys (e.g. Civey for Spiegel, Oct 2019) show that many voters tend to see the Green party as a "one-topic party" with a focus on climate policy. In addition, the Green party is primarily established in western Germany, above all in metropolitan areas. Based on these considerations, it seems questionable whether the Green party could become the senior partner in a possible conservative-green coalition (the only combination that could promise a majority in the parliament, according to current polls). Nonetheless, for the first time ever, the Greens are discussing nominating a candidate for chancellor. Given the party's preference for direct democracy, there seems a high probability that they will put the final decision to a member ballot.

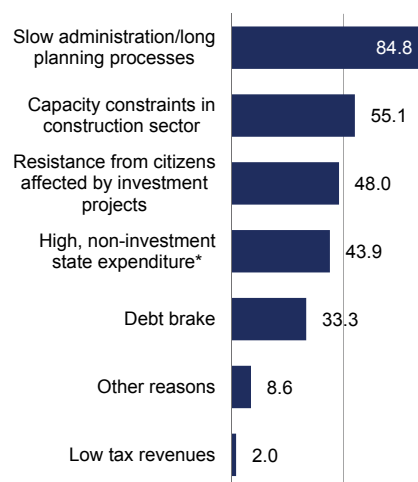
State elections in Hamburg one signpost in 2020. While this year the parties had to fight several state elections back to back, 2020 foresees just one in the city-state of Hamburg, on February 23. It will be the first test for the SPD party leadership with its new policy course in a city-state where the SPD has fielded the First Mayor for much of the past (one being FM Scholz). Polls (wahlrecht.de) indicate that the SPD might be challenged by the Green party, which tends to perform particularly strong in urban places. These prospects might further motivate the new SPD leadership to seek a successful renegotiation with the CDU/CSU on policy priorities for the second term of Groko in time for this state election.



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Impediments for public investment 87

Survey among financial market experts, %



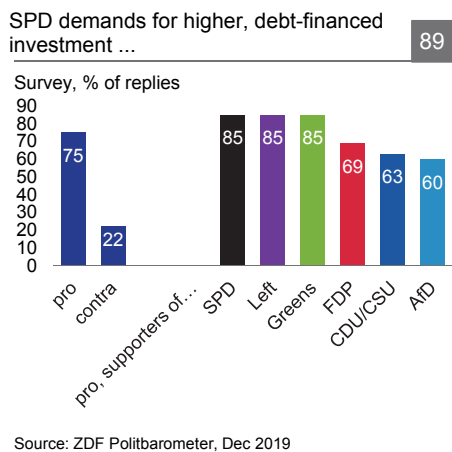
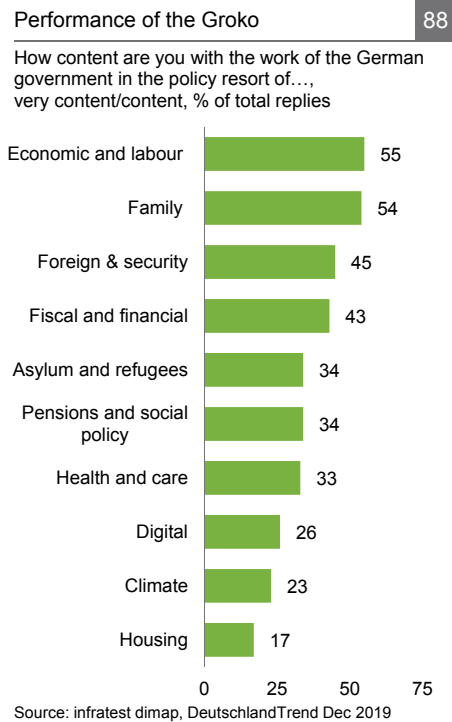
Source: ZEW 2019

No red lines for Groko but mandate to renegotiate policies. In contrast to earlier concerns, SPD delegates at the recent party convention gave their new leadership the mandate to continue the SPD work in the government but at the same time asked them with a clear majority to reopen discussions with their coalition partners CDU/CSU on a package of policy issues that focus on more left-leaning SPD positions. After these talks, the party executive under the new leadership should decide whether Groko should be continued. The major topics are:

- **Reconsidering black zero and debt brake.** There was no call for an immediate abolition of black zero, but the leadership duo in its statements heavily attacked the support for black zero by the party establishment. The moderate wording in the party convention's motion was not least aimed at preventing further damage for FM Scholz who defended the black zero publicly. In his most recent public interventions, though, he seems to have distanced himself from this political goal to a certain extent. According to the party resolution, the "debt brake" limiting the structural deficit to 0.35% of GDP should be overcome in the medium term to allow more public investment. If "overcoming" means abolition of the constitutional anchored debt brake, this would require a two-thirds majority in the Bundestag and the Bundesrat (upper house) – an unrealistic prospect given the party composition of the two bodies.
- **(Even) more public investment.** Over the next 10 years, the SPD wants to invest an additional EUR 450 bn for education, transportation, digital infrastructure and climate protection (currently the federal level is investing about EUR 40 bn p.a.). This number was brought to public debate by a rare alliance of the representatives of industry (BDI) and unions (DGB). While there is no dispute that Germany's public infrastructure needs a broad upgrade, severe capacity constraints in the construction industry as well as in public administration already hamper making full use of the current budget, let alone further spending. Still, the current fiscal situation beyond the already approved 2020 budget might allow additional (investment) spending in the lower-single-digit EUR billions even under the black zero paradigm and thus offer some leeway for reconciliation between the SPD and the CDU (see section on fiscal policy).
- **Increase in minimum wage.** The delegates demanded a minimum wage of EUR 12 (from EUR 9.35 as of 2020) further down the road. The coalition treaty already foresees the evaluation of the minimum wage law and the work of the independent Minimum Wage Commission in 2020 which will form the basis for talks between the new SPD leadership and the CDU/CSU. These talks will take place next year and a possible compromise between the CDU and SPD might be to modify the mandate of the Commission to allow more scope for minimum wage adjustments. An increase towards EUR 12 seems rather unlikely given the CDU/CSU position.
- **Reopening climate package.** Regarding the Groko's just-agreed climate package, the congress called for a higher price on CO₂ emissions above the currently foreseen EUR 10 per ton from 2021 onwards without putting a specific number to it. In speeches and statements, though, party co-leader Esken frequently mentioned a CO₂ price of EUR 40 for the not-so-distant future. A quick and substantial price increase had been rejected not least by the SPD state PMs on the grounds of burdening the man on the street with excessive costs. Still, there had been the chance to alter the package as it was subject to talks in the conciliation committee between the lower and the upper houses as tax issues related to the climate package such as compensation for commuters, lower VAT on train tickets or tax allowances for energetic housing require the approval of the upper house (representation of the German state governments, in some of which the Greens enjoy a strong role). Reportedly, the conciliation committee has meanwhile come up with a



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compromise of more than doubling the CO₂ price while providing for a higher compensation including a stronger social component (see section on climate policy). This should please the new leadership duo for the time being.

- Wealth tax revival in the context of fair taxation.** Delegates also decided on a 1-2 percent wealth tax affecting citizens with a net wealth of EUR 2 million (single) and EUR 4 million for couples while acknowledging that the implementation of it would take quite some time. Corporate wealth should be exempted partly from the tax to avoid double taxation. Nonetheless, the president of the ifo Institute, Clemens Fuest, warned that such a tax could raise the tax burden at the top from currently 47.5% to 72.5% with corresponding effects for growth and competitiveness. According to SPD plans, the revenue of such a 1% tax would be around EUR 9 bn. After a critical ruling by the Constitutional Court on an earlier design of a wealth tax, the tax has not been imposed since the 1990s. Taxing the “rich” will rank high on the profiling agenda of the SPD. New co-leader Walter-Borjans has earned the nickname of the taxpayers’ “Robin Hood” earned through his fight against tax evasion. But reducing the tax burden beyond the already-agreed partial abolition of the solidarity charge becomes even less likely in the new SPD set-up. This holds true for meaningful corporate tax reform as well. Esken said in an interview (Süddeutsche Zeitung) that this would require compensation elsewhere. FM Scholz just tabled plans for an FTT which at first sight fits neatly into this profiling – the impact of the FTT in its current design, though, would hit everyone, including the “small man on the street” saving for private old-age provisioning.

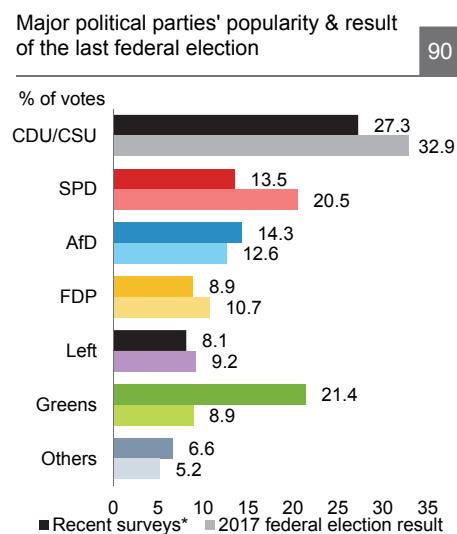
SPD repositioning to increase Groko tensions, but breakup unlikely. Overall, representatives from the CDU/CSU disapproved of the demands coming out of the SPD convention, with CDU leader AKK being particularly clear against renegotiations. This is understandable given the party-internal pressure on her to not continue the “social democratisation” of the CDU/CSU. Her CDU deputy, Armin Laschet, PM of North Rhine-Westphalia, showed himself more open to renegotiating the climate package. CDU/CSU and SPD leadership will meet before Christmas to discuss further proceedings. In the end, the tone of the SPD party congress as well as the responses from the CDU/CSU still support our view that the coalition partners will aim to find a working basis for continuing the government coalition. We expect that the Groko partners will continue their muddling through in the second part of their term without major policy shifts. As mentioned above, some face-saving compromises should be possible. Tensions between the two coalition partners will increase, though, given that

- The SPD is now represented by a leadership team less supportive of the Groko work, which might be tempted to criticise the work of their own party colleagues, who are part of the government. Esken, in particular, seems prepared to go down this road with her repeated critical comments about the role of FM Scholz (and more generally SPD cabinet members) – also raising questions about how long Scholz will accept this tone from new party leadership.
- Both coalition partners are keen to sharpen their political profiles ahead of the elections in 2021, which makes it more difficult to strike compromises even where a fundamental understanding of the need for policy action might prevail.

Political dynamics will remain difficult to predict and the risk of a break-up early next year remains, though the coalition parties’ weak performance in current polls should significantly lower their appetite for snap elections. According to the latest ZDF Politbarometer (Dec 13), at 69% a clear majority of SPD supporters consider staying in the government the superior option to going into opposition.



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* Average of major recent surveys (Emnid, Forsa, Infratest dimap, INSA)

Source: Wahlrecht.de, Dec 2, 2019

Fallout from coalition bickering on Germany's EU presidency in H2/ 2020. There is a significant risk that the internal tensions among the coalition partners weaken the government's negotiation position when Germany takes over the rotating EU presidency in the second half of next year. Ironically, Merkel will be faced with similar challenges as during her first, successful EU presidency in 2007, when she managed to strike an ambitious deal on climate and energy policy (the EU targets agreed for 2020 have been met only to a certain extent, though) and set the course for another EU treaty reform. This time, it will be about the plans of Commission President von der Leyen on a European Green Deal with the Commission's proposal presenting highly ambitious targets on CO₂. In addition, to achieve the goals vdl wants to invest EUR 3 tr in climate protection through 2030, half of it from the EU budget. This will not be possible without an increase of the EU budget for 2021-2027 from the current 1% of GNI to 1.14%, an increase that meets strong resistance by net-contributors including Germany. Given the controversies, there is a high probability that a last-minute agreement can only be found under a German presidency with Germany making substantial concessions in terms of funding. Furthermore, the EU agenda includes sensible topics such as the future of trade multilateralism, future relations with the UK and the German-French initiative to organise a convention on the "Future of Europe" possibly leading to institutional changes. Against this background, we still think that despite the political noise, neither SPD nor CDU/CSU senior politicians – let alone the German electorate – would want to miss out on Chancellor Merkel's experience and standing.

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German climate package: Limited effect in all respects

The macro-economic and fiscal effects of the German climate package will be within the range of statistical inexactness both in 2020 and in later years. The climate package does not change the general course of fiscal policy. While it does contain additional (cumulative) government spending of more than EUR 54 bn for the years 2020-2023 (or c. 1.6% of 2019 GDP), it should be largely self-financing, as it not only involves additional spending but also leads to additional revenue.

The climate package consists of four major elements. First, it contains general funding programmes for climate-protection measures and technology-specific subsidies. Second, it includes setting up a uniform pricing system for CO₂ in the transport and heating sectors (buildings). Third, revenues from carbon pricing are to be either reinvested in climate-protection measures (such as e-mobility or the envisaged swap premium for old oil-fired heating systems) or used to compensate private households for higher energy prices due to carbon pricing. The fourth element consists of additional command and control measures that will be specified or introduced later on, through 2030.

Introducing a carbon price in the transport and heating sectors aims to make climate policy more cost-efficient. The German conciliation committee worked out a compromise with a starting price of EUR 10 (from 2021) that is scheduled to rise to EUR 55 per tonne by 2025. Thus, the initial price signals are moderate: At EUR 55 per tonne of CO₂, less than 15 cents will be added to the cost of a litre of petrol or diesel. The ecological steering effect of higher fuel prices of this size is limited, given that the price elasticity of fuel demand is relatively low. What's more, car drivers usually get used to higher fuel prices after a certain



time.⁶ The climate package also includes a lower VAT rate on long-distance railway travel, a higher commuter allowance and a decline in the EEG levy.

The climate package is a typical political compromise. It is an attempt to support global climate protection by means of national measures without putting too much pressure on private households and corporates. From today's vantage point, the measures will be clearly insufficient to reach the 2030 climate target of reducing CO₂ emissions by at least 55% compared to the level of 1990. To reach this goal, higher carbon prices and/or stricter command and control regulation would be necessary. The climate package contains an annual monitoring process. Additional climate policy measures can be introduced if it becomes apparent that climate targets will be missed. However, fringe parties would likely gain momentum if the financial burden on private households rose sharply due to climate policy measures.

The uncertainties about the long-term direction of German climate and energy policy will remain a drag on domestic investment spending in several sectors. In particular, this applies to energy-intensive industries such as the metal and chemical industry. In absolute terms, electricity prices are not the most important burden for most energy-intensive companies because they usually benefit from exemptions within the framework of the German Renewable Energy Act (EEG) or the EU Emissions Trading System (EU ETS). Instead, investment activity is hampered by uncertainty about how long these exemptions will remain in place. Overall, real capital stock has been declining in these sectors for many years.

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⁶ Under the so-called eco tax in Germany, taxes on petrol and diesel were raised by more than 15 cents per litre in five steps between 1999 and 2003. As a result, domestic fuel sales initially declined, but largely due to "fuel tourism" and more efficient vehicles. After a number of years, domestic fuel sales increased again. The motorised individual transport volume increased quite steadily despite the eco tax.



Key events – Outlook 2020

2020 Calendar of the year

January 15	Gross domestic product 2019 incl. press conference of the Federal Statistical Office
January 31	Brexit deadline: UK expected to leave the EU
February 14	Gross domestic product Q4 2019, flash reading without details
February 23	Elections in the City State of Hamburg
February 25	Gross domestic product Q4 2019, 2nd reading with details
March 15	Expiry (and possible extension) of current EU sanctions against Russia
April*	Start collective bargaining rounds 2020 in the metal and electrical industries in 2020: Usually two to three rounds of negotiations in following two months
May 15	Gross domestic product Q1 2020, flash reading without details
May 25	Gross domestic product Q1 2020, 2nd reading with details
Mid-May	Working party on tax estimates will publish tax revenue projections
End-May/early June	Publication of construction completions 2019, Federal Statistical Office
May/June*	Financial Stability Committee (AFS): Report to the German Bundestag on financial stability. Possible proposals/interventions in mortgage lending with effects on the real estate market
June 18-19	European Council to finalise Green Deal
June 30	Deadline for UK requesting extension of post-Brexit transition period
July 1	Germany takes over EU Council Presidency until the end of 2020
August 14	Gross domestic product Q2 2020, flash reading without details
August 25	Gross domestic product Q2 2020, 2nd reading with details
September*	Collective bargaining rounds 2020 in the public sector (federal government and municipalities): Usually two to three rounds of negotiations in following two months
Autumn*	Judgement on the complaint of review of the norms for the Berlin rent cap
Autumn*	Berlin referendum on the expropriation of real estate companies with more than 3,000 apartments
November 3	US presidential elections
November 13	Gross domestic product Q3 2020, flash reading without details
November 24	Gross domestic product Q3 2020, 2nd reading with details
Early November	Working party on tax estimates will publish tax revenue projections
December 10-11	European Council to agree on multiannual financial framework
Early/mid-January	Gross domestic product 2020 incl. press conference of the Federal Statistical Office
2021 September*	Federal election

*presumably

Source: Deutsche Bank Research



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- ▶ Outlook 2020: Fragile – handle with care December 20, 2019
- ▶ Economic weakness, political turbulence November 4, 2019
- ▶ Climate package:
No game changer for fiscal policy September 30, 2019
- ▶ Only a technical recession?
It is all about risks! August 19, 2019
- ▶ A looming black-green coalition:
Painful compromises needed July 8, 2019
- ▶ Not out of the woods, politics of no help May 20, 2019
- ▶ Exports and autos weigh heavily
on the German economy in 2019 April 9, 2019

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