



Not out of the woods, politics of no help

May 20, 2019

Authors

Josef Auer
+49 69 910-31878
josef.auer@db.com

Sebastian Becker
+49 69 910-21548
sebastian-b.becker@db.com

Barbara Böttcher
+49 69 910-31787
barbara.boettcher@db.com

Dieter Bräuninger
+49 69 910-31708
dieter.braeuninger@db.com

Eric Heymann
+49 69 910-31730
eric.heyman@db.com

Orçun Kaya
+49 69 910-31732
orcun.kaya@db.com

Kevin Körner
+49 69 910-31732
kevin.koerner@db.com

Editor
Stefan Schneider

Deutsche Bank AG
Deutsche Bank Research
Frankfurt am Main
Germany
E-mail: marketing.dbr@db.com
Fax: +49 69 910-31877

www.dbresearch.com

DB Research Management
Stefan Schneider

Content	Page
Forecast tables.....	2
German economy - not out of the woods	3
German automotive business cycle	5
Mechanical engineering: Weak start 2019	8
Tax revenue estimates: Reality check	10
The view from Berlin: CDU and SPD	13
EU elections countdown: Germany?	16
Taxing the digital economy	17
Loose financial conditions in Germany	18
DB German Macro Surprise Index.....	20
Data calendar.....	21
Financial forecasts	22
Data monitor.....	23

German economy – not out of the woods. After Q1's 0.4% qoq GDP increase, we expect growth to flatline in Q2 and remain muted in H2. Neither hard nor soft data suggest that the manufacturing sector has reached its nadir. Still, Q1's growth spike has prompted us to lift this year's GDP forecast from 0.5% to 0.7%.

German automotive business cycle. Production and capacity utilisation increased slightly at the beginning of 2019. However, sentiment indicators are still in negative territory. Global car demand continues to decline in yoy terms. We expect a recovery in domestic automotive production in H2 2019.

Mechanical engineering: Weak start into 2019 with loss unlikely to be recovered during the remainder of the year. In Q1 2019, order intake dropped 7.3% qoq. While a large order backlog continues to support production in this cyclical sector, output in Q1 2019 was down about 1% qoq. The weak spell in the German industry is evidently a result of the global slowdown in demand rather than caused by special factors.

Tax revenue estimates: Reality check for fiscal policy. Germany faces the inevitable prospect of federal deficits in the years ahead even exceeding those previously planned, with the reserve fund for refugees unlikely to fully cover them. Sticking to the "black zero" brings the potential for severe disputes over the future fiscal course.

The view from Berlin: CDU and SPD – (premature) internal bickering over post-Groko politics. Poor results for the Groko parties in the European and Bremen elections could spell trouble. But we do not expect an immediate Groko breakup. In late autumn, in the aftermath of the election in east Germany, tensions could heat up again.

EU elections countdown: What about Germany? The expected shift of voters' support from CDU/CSU & SPD to FDP & Greens will not change Germany's pro-European stance, despite diverging views e.g. on euro area reforms. The AfD's result should be rather underwhelming when compared to EU sceptic parties in other countries.

Taxing the digital economy: Good reasons for scepticism. The international community is working on solutions which are to be presented by (end-) 2020. The German and the French government favour an effective minimum tax.

The message from loose financial conditions in Germany. Loan spreads narrowed, bond spreads decreased and bank lending standards were favourable, but economic growth and financial conditions have partly decoupled in recent years. Yet, loose financial conditions have so far not led to excessive borrowing.



Not out of the woods, politics of no help

Economic forecasts

	Real GDP (% growth)			Consumer Prices* (% growth)			Current Account (% of GDP)			Fiscal Balance (% of GDP)		
	2018	2019F	2020F	2018	2019F	2020F	2018	2019F	2020F	2018	2019F	2020F
Euroland**	1.8	0.9	1.3	1.8	1.3	1.4	2.9	2.3	2.0	-0.5	-1.0	-1.0
Germany	1.4	0.7	1.2	1.9	1.7	1.4	7.4	6.5	6.1	1.7	0.8	0.5
France	1.6	1.3	1.3	2.1	1.5	1.7	-0.3	-0.3	-0.2	-2.5	-3.2	-2.0
Italy	0.9	0.3	0.7	1.2	1.2	1.4	2.5	2.2	2.2	-2.1	-2.4	-2.2
Spain	2.6	2.1	2.0	1.7	1.3	2.0	0.9	1.2	1.0	-2.5	-2.2	-1.8
Netherlands	2.7	1.9	1.8	1.6	2.3	2.0	10.8	9.9	9.7	1.5	0.6	0.4
Belgium	1.4	1.4	1.4	2.3	1.8	1.6	-1.3	0.4	0.5	-0.7	-1.3	-1.4
Austria	2.8	1.9	1.8	2.1	1.6	1.8	2.3	2.3	2.5	0.1	0.1	0.3
Finland	2.3	1.9	1.8	1.2	1.3	1.5	-1.9	0.0	0.5	-0.7	-0.7	-0.6
Greece	1.9	1.9	1.8	0.8	1.0	2.7	-2.9	-0.6	-0.3	1.1	1.1	1.3
Portugal	2.1	1.7	1.5	1.2	0.7	1.6	-0.4	0.0	0.0	-0.5	-0.7	-0.6
Ireland	6.8	3.4	3.3	0.7	1.0	1.1	9.1	10.0	9.0	0.0	0.0	0.3
UK	1.4	1.5	1.3	2.5	1.9	2.2	-3.9	-3.3	-3.0	-1.5	-1.9	-1.5
Denmark	1.4	1.9	1.7	0.7	1.5	1.8	5.8	6.2	6.1	-0.3	-0.2	0.2
Norway	1.8	2.1	2.0	2.8	2.1	2.0	8.1	6.0	6.1	7.2	5.3	5.2
Sweden	2.4	2.0	1.9	2.0	1.9	1.9	2.0	3.1	3.1	1.7	0.9	0.6
Switzerland	2.5	1.4	1.6	0.9	0.8	1.1	10.2	10.3	10.7	0.4	0.5	0.4
Czech Republic	2.9	2.8	3.0	2.1	2.6	2.1	0.3	0.5	0.7	0.9	1.0	0.9
Hungary	4.9	3.5	3.1	2.9	3.5	3.2	0.5	0.3	0.9	-2.2	-1.9	-1.8
Poland	5.1	3.8	3.4	1.8	2.1	2.9	-0.7	-1.2	-1.2	-0.3	-1.9	-2.4
United States	2.9	2.6	1.9	2.4	1.9	2.1	-2.4	-3.5	-3.5	-3.8	-4.2	-4.1
Japan	0.8	0.3	0.2	1.0	0.5	0.7	3.4	3.7	4.1	-2.2	-2.0	-1.9
China	6.6	6.3	6.0	2.1	2.4	2.5	0.4	-0.2	-0.4	-4.2	-4.5	-4.0
World	3.8	3.4	3.5	3.3	3.1	3.0						

* Consumer price data for European countries based on harmonized price indices except for Germany. This can lead to discrepancies compared to other DB publications.

** GDP forecasts currently under review

Sources: National Authorities, Deutsche Bank

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

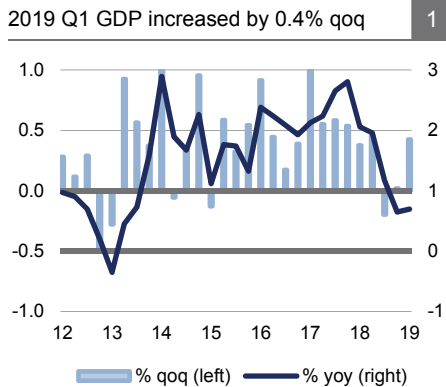
	2017				2018				2019F				2020F			
	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Real GDP	2.2	1.4	0.7	1.2	0.4	0.0	0.1	0.3	0.2	0.2	0.3	0.3	0.2	0.2	0.3	0.3
Private consumption	1.8	1.0	0.9	1.2	0.4	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Gov't expenditure	1.6	1.0	1.5	1.3	-0.1	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Fixed investment	2.9	2.6	3.2	2.7	1.5	0.2	0.6	0.6	0.5	0.4	0.4	0.5	0.5	0.4	0.4	0.5
Investment in M&E	3.7	4.2	2.3	2.2	1.0	0.5	0.5	0.5	0.3	0.0	0.0	0.3	0.3	0.0	0.0	0.3
Construction	2.9	2.4	4.8	3.7	2.5	0.0	0.8	0.8	0.8	0.7	0.7	0.7	0.8	0.7	0.7	0.7
Inventories, pp	0.1	0.5	-0.2	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	0.0	0.0	0.0	-0.1	0.0	0.0	0.0
Exports	4.6	2.0	1.6	3.2	0.6	0.5	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Imports	4.8	3.3	3.5	3.8	0.7	0.8	0.8	0.8	0.8	0.8	0.7	0.7	0.8	0.8	0.7	0.7
Net exports, pp	0.2	-0.4	-0.7	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0	-0.1	-0.1	0.0	0.0
Consumer prices*	1.7	1.9	1.7	1.4												
Unemployment rate, %	5.7	5.2	4.9	4.7												
Industrial production**	2.9	1.1	0.0	1.0												
Budget balance, % GDP	1.0	1.7	0.8	0.5												
Public debt, % GDP	64.5	60.9	58.3	56.0												
Balance on current account, % GDP	8.0	7.4	6.5	6.1												
Balance on current account, EUR bn	261.2	249.1	226	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



German economy – not out of the woods



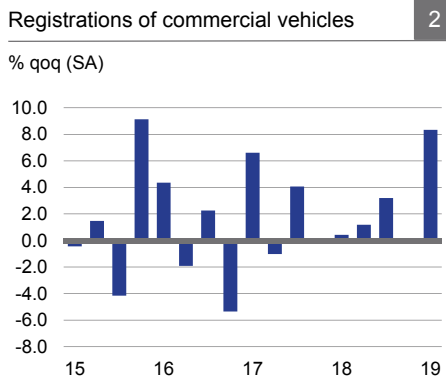
Sources: Federal Statistical Office, Deutsche Bank Research

- After Q1's surprising 0.4% qoq GDP increase, we expect growth to flatline in Q2 and remain muted in H2.
- Neither hard nor soft data suggest that the manufacturing sector has reached its nadir. Together with recent increases in geopolitical tensions this suggests a less dynamic H2 pickup than previously thought.
- While the basis effect of Q1's growth spike on the remaining quarters' yoy rates has prompted us to lift this year's GDP forecast from 0.5% to 0.7%, it also implies that 2020's annual growth rate will – ceteris paribus – fall short of the 1.4% we had expected so far.

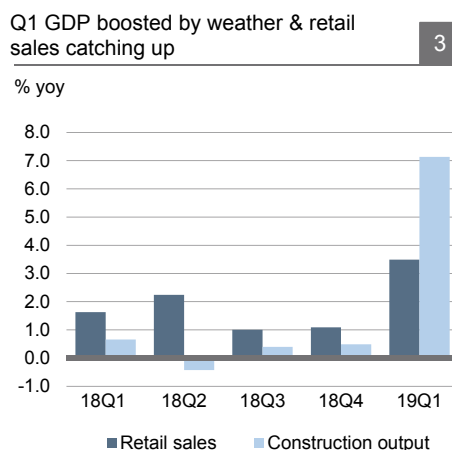
Q1 positive surprise

In Q1 German real GDP rose by 0.4% qoq (Q4 '18: 0.0%). This increase was in line with consensus as bridge models based on IP and retail sales had gravitated towards 0.4% as the Jan.-Mar. monthly data became available. However, the increase was clearly above expectations held at the start of year. We even saw the risk of a negative quarter, given that the ifo index and the manufacturing PMI fell in Q1 with even faster rates than in Q4 and only the composite PMI started to stabilise.

As usual, the Federal Statistical Office will release numerical information on the GDP expenditure components only later (23 May 2019). According to the Stats Office's press release GDP was pushed by investments - we assume mainly in construction but also in M&E investment as indicated by the 8.3% qoq jump in commercial vehicle registrations in Q1. In addition, private consumption expenditure also rose markedly compared with the previous quarter. The positive development of these components can be attributed to a considerable extent to one-off effects. Construction benefited from the favourable weather conditions. Construction output in Q1 jumped 3.9% qoq and was up 7.1% on the year, as the balance of reports of adverse weather conditions (ifo survey) even dropped into negative territory in March. Consumption increased on the back of a very sluggish trend in H2 in 2018, but should also have benefited from positive wage developments, ongoing labour market strength and a partial reversal of the 0.9 point rise in the savings rate during 2018. Government consumption decreased following a 1.6% qoq surge in Q4 2018. Net foreign trade probably did not contribute to growth.



Source: ECB



Source: Federal Statistical Office

Back to stagnation in Q2 as IP has not yet bottomed out

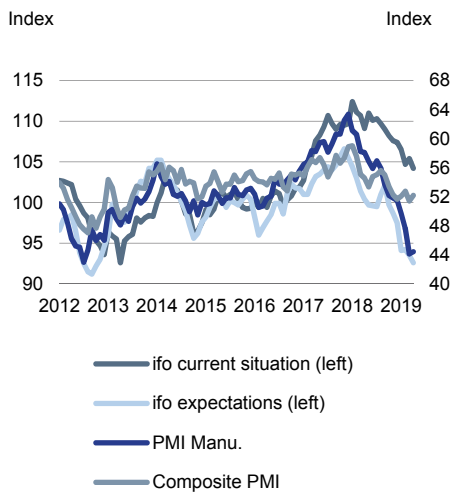
A negative payback in Q2 has to be expected as: (1) special factors which boosted Q1 growth will reverse. The ifo survey suggests that construction output will expand by less than Q1's 3.9% qoq. (2) Manufacturing output stagnated in Q1 (-0.1% qoq), but output expectations (ifo/PMI) do not suggest that the trough has already been reached. In the auto industry output and output expectations slumped in April suggesting that there is still no normalization following last year's WLTP shock. (3) Contrary to earlier expectations the Brexit saga and probably even more importantly – as temporary better news started to show up in some survey data – the renewed escalation of the US/China trade war and the rising tensions in the Middle East should weigh on sentiment and activity. In this regard President Trump's announcement to delay any tariff increases for US car imports for 180 days is probably only a minor positive.



Not out of the woods, politics of no help

Export/investment nexus to weigh on growth

Sentiment: No real silver lining **4**



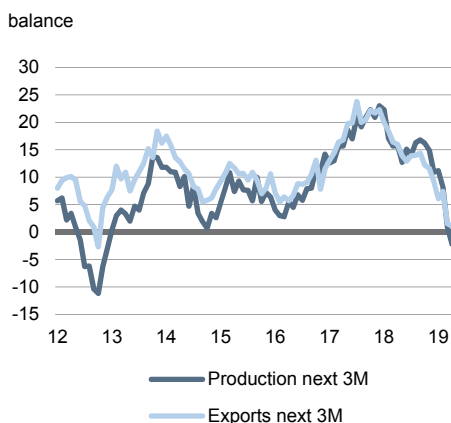
Sources: ifo, IHS Markit

The German economy is paying tribute to the global trade cycle, which is still not showing signs of bottoming out, with global new export orders (PMI) staying at around 49 since February. Foreign orders rose 4.2% mom in March thus reversing most of their -5.8% slump in February. But this was due to large EMU orders for transport equipment. Ex-transport orders rose a meagre 0.2% mom following four months of straight losses, with Q1 down -5.2% v. Q4 (-7.4% yoy). Survey data regarding exports remains at depressed levels (PMI) or has fallen further (ifo). The bleak export outlook and increasing geopolitical uncertainty are straining capex investment, too. In Q1 domestic core capital goods orders (ex cars & aircrafts) were down 3.2% qoq (-2.5% yoy). The decline in capacity utilization starting in Q1 2018 has become more pronounced in the first half of this year, although at 85.4 it is still above the long-term average (83.6).

Inventory investment dropped 0.6pp in Q4 after rising by 0.8pp in Q3 (contribution to GDP), with WLTP leaving a strong mark. Still, the inventory assessment in the ifo business climate does not suggest that the inventory correction has been completed.

Consumption and construction to keep the economy afloat

Downbeat expectations in manufacturing **5**



Source: ifo

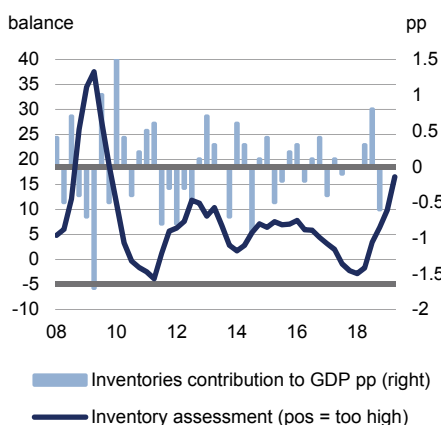
Retail sales expanded by 1.6% qoq in Q1. The labour market has remained robust with the unemployment rate falling to 4.9% in March. Overall hiring intentions remain strong (ifo, PMI), notwithstanding the drop below 50 in the manufacturing PMI's employment index. Consumer confidence has remained roughly stable in 2019. Loose financing conditions and more government spending for housing should continue to drive construction investment, leading to healthy expansions once the negative payback in Q2 is overcome.

GDP to grow by 0.7% in 2019 despite more subdued outlook

Notwithstanding the Q1 surprise the outlook for the rest of the year has become more clouded. Activity in Q2 will suffer from a negative payback for Q1's one-offs, in particular with regard to construction output. Even more important, the de-escalation of geopolitical tensions seen as the catalyst for a global economic recovery in H2 seems to have become considerably less likely in recent weeks. More subdued expectations already showed up in the latest ZEW survey (May) which fell back to -2.1 (April: 3.1) after improving for 6 months in a row. Compared to ifo or the PMI, the ZEW survey tends to be a better proxy for GDP growth two or three quarters ahead. Still, assuming flat GDP for Q2 and just 0.1% growth for Q3, it would require a negative GDP print for Q4 to hit our 0.5% forecast for the year. This might well be possible, if geopolitics took another turn for the worse, but this is currently not our house view. Therefore we have lifted our GDP forecast to 0.7%. This year's flatter profile will – ceteris paribus – reduce the average growth rate in 2020. We now expect 1.2%, of which 0.4pp are courtesy of a positive working day affect.

Stefan Schneider (+49 69 910-31790, stefan-b.schneider@db.com)

Inventory adjustment **6**



Sources: ifo, Federal Statistical Office



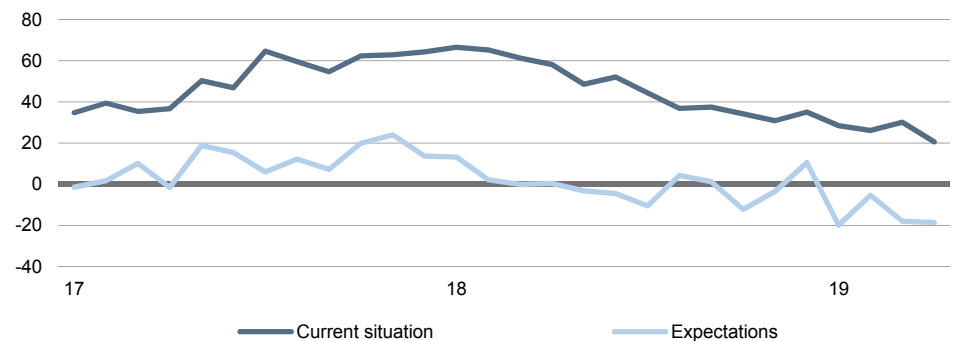
German automotive business cycle

The automotive industry is the largest industrial sector in Germany, measured by revenue. Its performance will decide if the German industrial sector successfully comes out of the recession that has started in Q3 2018. The sector is currently working towards overcoming the WLTP induced dip of H2 2018. At the same time global demand has slowed significantly. While domestic order intake declined at the latest reading, output seems to stabilise of late. However, business expectations and expectations with regard to production activity (ifo, April data) are pessimistic. In terms of foreign trade, it is relevant for the German automotive industry that US President Trump has decided not to introduce higher tariffs on automotive imports for now. However, this decision might be reversed later this year.

ifo business climate

1

Automotive industry in Germany, balance of positive and negative company reports (%)



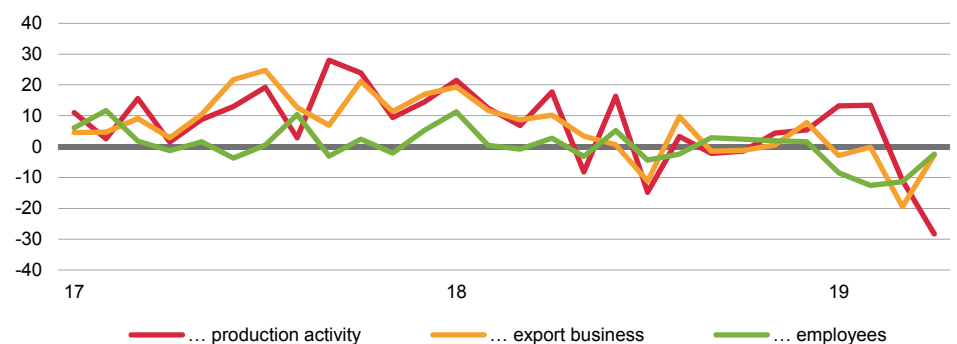
Source: ifo

Chart 1: Business expectations in the German automotive industry have been negative since the beginning of the year, not least due to weaker global demand for cars. In contrast, companies are still optimistic about the current situation, probably due to the large order backlog. However, order backlog declined slightly in February.

ifo expectations with regard to ...

2

Automotive industry in Germany, balance of positive and negative company reports (%)



Source: ifo

Chart 2: The pessimistic expectations of the sector are reflected in the subcomponents of the ifo survey. Production expectations in particular have recently declined considerably. This did not come as a surprise, as global car demand is slowing and the environment for world trade is difficult (Brexit, threat



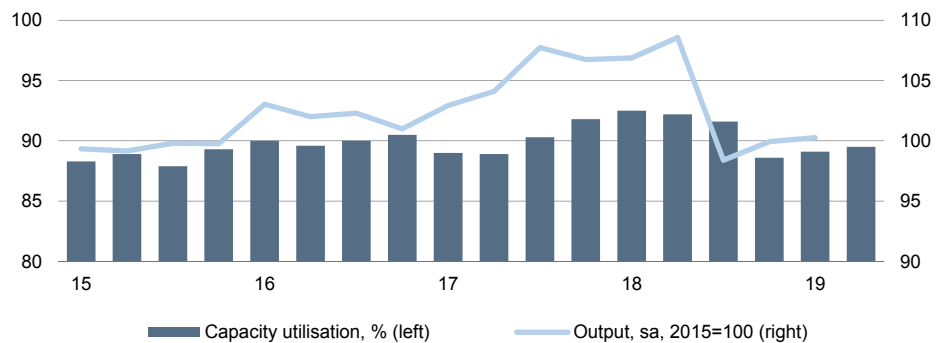
Not out of the woods, politics of no help

of US tariffs). Export and employment expectations improved of late, though. Employment in the sector will still decline slightly in 2019.

Output and capacity utilisation

3

Automotive industry in Germany



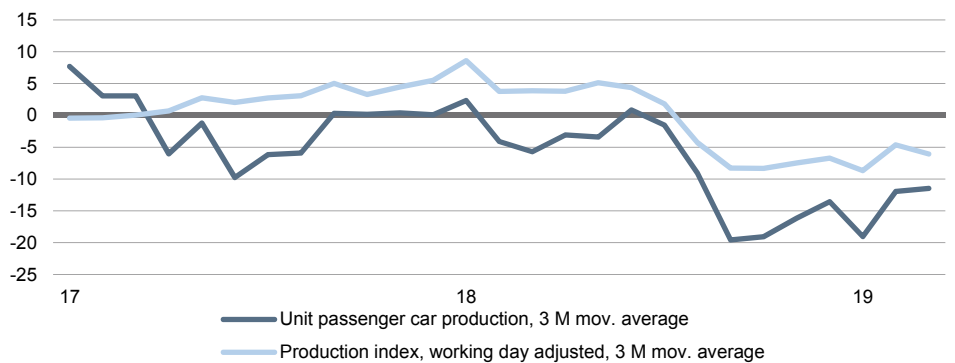
Sources: Federal Statistical Office, ifo

Chart 3: At the beginning of 2019, capacity utilisation in the German auto industry was considerably lower than in the first three quarters of 2018, but still above the long-term average. The renewed slight increase in capacity utilisation at the beginning of Q2 2019 suggests that domestic production activity might pass the trough in H1 2019.

Automotive production

4

Automotive industry in Germany, % yoy



Sources: Federal Statistical Office, VDA

Chart 4: German car production (in unit terms) was considerably down in year-on-year terms in the first months of 2019. March production (-15% yoy in unit terms) was particularly disappointing. The decline in the output index, which also includes qualitative criteria (such as better equipment of cars), will be smaller. According to the Federal Statistical Office, output index increased by 0.3% qoq in Q1 2019. The year-on-year growth rate looks set to turn positive again in H2 2019, as the WLTP effect pushed down the basis for comparison during H2 2018.



Not out of the woods, politics of no help

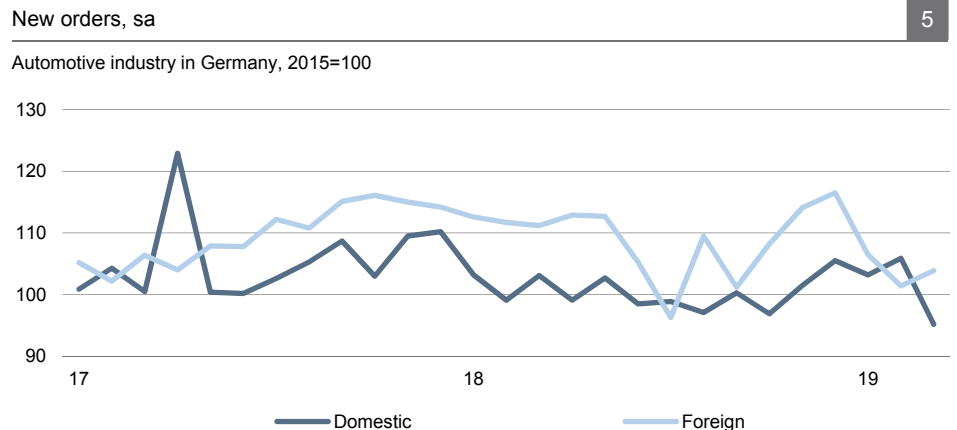


Chart 5: Domestic order intake declined significantly in March 2019 (-10% mom). However, the downward trend in foreign orders came to a halt of late. German new passenger car registrations trended sideways at a high level in the first four months of 2019. Export orders look set to pick up again from H2.

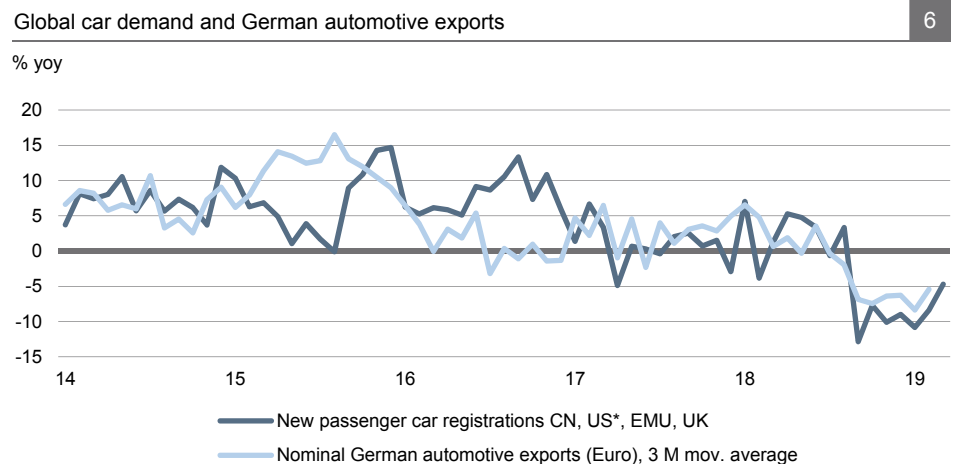


Chart 6: Weak demand in important German export markets towards the end of 2018 and at the beginning of 2019 weighed on auto exports. On average, exports are likely to decline in year-on-year terms during H1 2019.

Eric Heymann (+49 69 910-31730, eric.heyman@db.com)

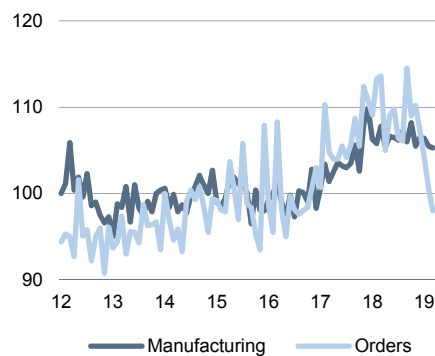


Mechanical engineering: Weak start into 2019 with loss unlikely to be recovered during the remainder of the year

Disappointing start to the year

1

Engineering in Germany, sa, 2015=100



Source: Federal Statistical Office

Sentiment significantly worsened

2

Engineering sentiment in Germany, balance of positive and negative company news



Source: ifo

- German mechanical engineering did not register a significant production overhang at the beginning of 2019. And in Q1 2019, order intake dropped 7.3% qoq. While a large order backlog continues to support production in this cyclical sector, output in Q1 2019 was down about 1% qoq. The weak spell in the German industry is evidently a result not only of the often mentioned one-off effects, such as WLTP or low water in the Rhine, but also of the global slowdown in demand for industrial goods.
- Even if production picks up as expected during the second half of the year, mechanical engineering output looks set to decline by 1–2% this year and thus decrease for the first time since 2013, when it dropped by 1.6%. This decline will be considerably more manageable than that in 2009, when mechanical engineering output shrank by 26% due to the global economic crisis. All in all, mechanical engineering companies will not need to act quickly.

2018 was the fifth year in a row in which mechanical engineering output rose. Not least thanks to a production overhang from 2017, mechanical engineering companies increased their output by 2.2% in price adjusted terms. Production reached its peak in October 2018; since then, the trend has been pointing downwards. This is also evident from capacity utilisation in mechanical engineering, which has declined from 90.5% in October 2018 to 87.4% by the beginning of April 2019.

According to the ifo institute, mechanical engineering companies are considerably more subdued about their current business situation than a year ago. Assessments have declined until recently, but are still clearly above the long-term average. In contrast, business expectations have been negative since November 2018. While they did not deteriorate further in April (for the first time in six months), it is probably too early to regard this development as a sustainable turnaround. We do not think that sentiment indicators and order intake point to an improvement in mechanical engineering in Q2 already.

The slowdown in mechanical engineering is due to several factors. First, weaker global growth has an impact on mechanical engineering, which is highly export-dependent; at 63%, the sector's export ratio is above the average for manufacturing as a whole (50%). Exports are suffering not only from the tensions related to the US/China trade conflict, which have recently increased again. This conflict is relevant because the US and China are the top two customer countries. Taken together, they bought 22% of total German mechanical engineering exports in 2018 (USA: 11%; China: 10.7%). Second, US threats of sanctions against Europe and Germany in particular have also had an unfavourable effect, not least because they focused on important mechanical engineering customers, such as the auto industry. North America is not only an important sales market for German carmakers, but also a major production location (just like Mexico). Relations with Russia and Brexit are key issues for mechanical engineering companies and their customers, too. They weigh on the sector's momentum as well. In 2018, 47% of the German mechanical engineering sector's total exports went to the EU-28. All in all, the numerous global tensions are highly relevant for German mechanical engineering companies and weigh on their sales.



Global conflicts to dampen growth in mechanical engineering in 2019

Peak passed

3

Engineering in Germany, order backlog, sa, 2015=100



Source: Federal Statistical Office

By now, the uncertainties stemming from the global trade conflict and from subdued business with important industrial customers in Europe have left palpable traces. A number of sectors are affected, from the auto industry to subsectors of electrical engineering and the metals industry. The subdued outlook for these customer sectors of mechanical engineering makes them reluctant to invest in new machines (or mechanical engineering solutions). However, there is one major exception, namely domestic construction. This sector is still doing well, which is why domestic demand for construction machinery and building material facilities is quite stable. Mining machinery is another positive exception. German mechanical engineering companies benefit from relatively stable developments in the global iron and non-iron metals business.

The situation in mechanical engineering might gradually stabilise from Q3. However, despite the expected pickup in production, output in 2019 as a whole is likely to decline by 1–2%. The large order backlog will support output, even though it has declined slightly in recent months.

Mechanical engineering would certainly benefit if the current tensions between the US and China abated. The fact that interest rates are extremely low in a long-term comparison might lead to a gradual pick-up in investment and, in time, support mechanical engineering; however, this is nothing new. If the euro does trade a bit stronger by end-2019 German mechanical engineering companies might be slightly less competitive outside the euro area. However, a stabilisation of global growth, particularly in North America and China, would more than outweigh this effect.

Josef Auer (+49 69 910-31878, josef.auer@db.com)

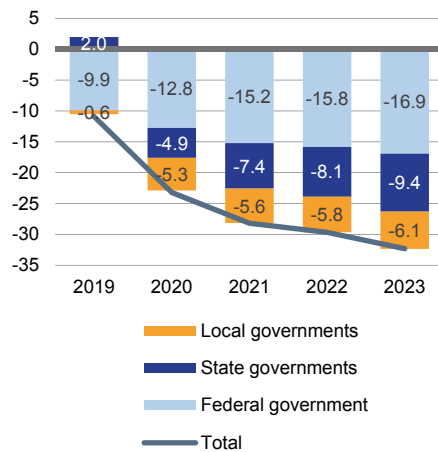


Not out of the woods, politics of no help

The weakening economy weighs on tax revenue developments

1

Difference of tax estimates, May 2019 vs. Oct 2018, EUR bn

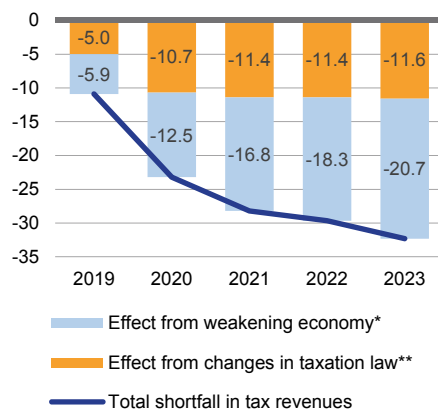


Sources: Working Party on Tax Revenue Estimates, Ministry of Finance, Deutsche Bank Research

But also changes in tax laws weigh on tax receipts

2

Tax revenues (gen. gov.), Tax estimates as of May 19 vs. as of Oct. 18, EUR bn



* Difference in estimates due to economic reasons and unexpected behavioural changes by economic agents.
** including changes regarding EU payments

Sources: Working Party on Tax Revenue Estimates, Ministry of Finance, Deutsche Bank Research

Tax revenue estimates: Reality check for fiscal policy

Changes in tax legislation and weakening economy are undermining the tax revenue outlook

Now it is official, though hardly a surprise! Entailing sharp losses of tax revenues across all levels of the government (federal government, the federal states, the local authorities), the slowdown in the German economy will have pronounced negative effects on public finances. Although the German government's tax intake will continue to rise according to the recent projections of the Working Party on Tax Revenue Estimates, tax growth is likely to be far more moderate than expected last autumn.

The shortfall in tax revenues can be ascribed to the federal government's downward revisions to its growth projections. According to the forecast of April 2019, the German economy is now expected to grow by only 0.5% in the current year, down sharply from 1.0% (DB forecast for 2019: 0.7%). In its autumn forecast, which served as the basis for the previous tax estimate (of October 2018), the government even foresaw real GDP growth of 1.8% in 2019.

On the basis of the recent tax estimate of May 2019, tax intake through 2023 looks set to be EUR 124.3 bn lower than previously expected. The brunt will probably be borne by the federal government, with tax losses in the five years ahead likely to amount to EUR 70.6 bn (compared with the October tax estimate). At EUR 27.7 resp. 23.3 bn, tax shortfalls of the federal states and local authorities will probably also be substantial, albeit much less so than those faced by the federal government (see Chart 1).

Alongside the downward revisions to the macro assumptions (GDP growth, wage growth as well as increases in corporate and investment income)¹, the decline in tax intake can also be traced to some changes the federal government introduced to German tax legislation such as the reduction of the tax burden on families ("Starke-Familien-Gesetz") and cold progression allowances. Following from the calculations of the Federal Ministry of Finance i.e. the Working Party on Tax Revenue Estimates, changes in tax legislation actually account for a significant share of EUR 50.1 bn (general government), whereas a further EUR 74.2 bn can be ascribed to the economic slowdown. This year the effects of legislative amendments and the economic downturn on the general government's tax revenues are still more or less balanced (see Chart 2).

At the federal level, roughly half of the (cumulative) decline expected over the forecast horizon from 2019 to 2023 can be attributed to changes in tax legislation (including changes to EU payments), the other half to the negative cyclical backdrop. The "legislative effect" will result in total tax losses of EUR 35.5 bn, compared with an estimated shortfall of around 35.1 bn from the weakening economy.

¹ The recent tax estimate is based on real GDP growth of 0.5% in 2019 and 1.5% in 2020 (prev.: 1.8% in each year). Nominal GDP is expected to pick up by 2.8% in 2019 (prev.: 3.8%), 3.5% in 2020 (3.7%) and 3.0% per year from 2021-23 (3.2%). Given still outstanding labour market conditions, gross wage and salary projections (the key drivers of payroll tax growth) for 2019 were raised to 4.4% (prev.: 4.2%), followed by a slight downward revision to 3.9% (4.0%) for 2020. These changes reflect the ongoing very good labour market developments. For the period from 2021-23, forecasts were trimmed back to 2.8% per year (2.9%). The key drivers of earnings-related taxes, i.e. corporate and investment income, on the other hand, were lowered sharply. For 2019 and 2020, the growth forecasts were revised down to -1.5% (from 2.9%) and 2.9% (3.5%), respectively.

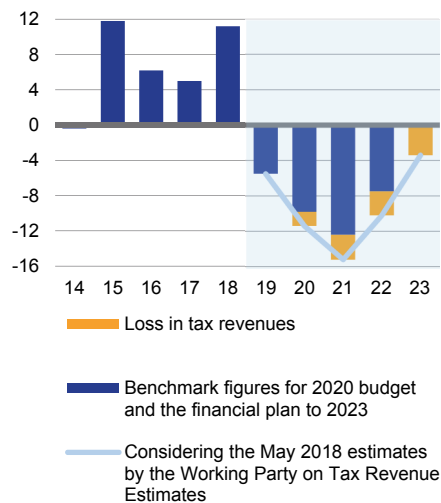


Not out of the woods, politics of no help

Federal government financial deficits are even larger than envisaged

3

Federal government financial balance*, EUR bn



* Excl. payments in and withdrawals from reserve funds, respectively.

Sources: Working Party on Tax Revenue Estimates, Ministry of Finance, Deutsche Bank Research

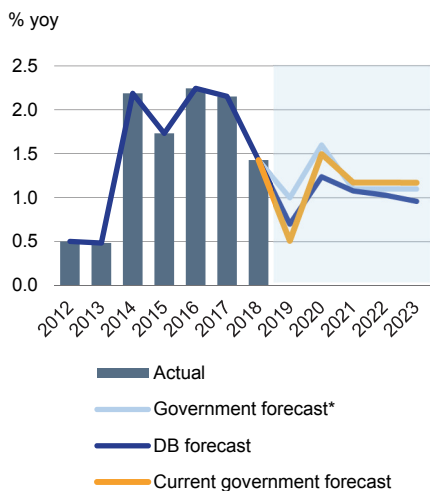
Reserve fund for refugees will probably no longer suffice to cover deficits

Just as a brief reminder: The federal government's key parameters – i.e. the benchmark figures for the 2020 budget and the financial plan to 2023 (as of March 2019) – already foresaw ongoing deficits in the federal budget, at least up until fiscal year 2022. Under the financial plan, a return to a balanced federal budget (excluding withdrawals from reserves) was not expected before 2023. According to the key parameters, fiscal deficits incurred in the upcoming financial period should be covered by fully depleting the reserve fund for refugees² (see Charts 6 and 7), enabling the federal government to stick to its fiscal goal of a "black zero" (no new net borrowing) amid the current downturn, courtesy of credit authorisations that were accrued in the preceding years (and have not yet expired).

Following the recent tax estimate, however, Germany faces the inevitable prospect of federal deficits in the years ahead even exceeding those in the previous financial plans. Based on the recent tax estimate of May 2019, the cumulated tax intake of the federal government from 2019-23 will be EUR 70.6 bn lower than forecast in October 2018. Relative to the previous financial plans, however, the negative budgetary impact ought to be much smaller, as the tax shortfalls coming on the heels of weaker growth and changes to tax legislation had largely been factored into the financial planning by Finance Minister Olaf Scholz. According to the Federal Ministry of Finance, tax revenues of the federal government as a whole – i.e. throughout the entire planning period from 2019 to 2023 – will undershoot assumptions in the key parameters of March by "only" EUR 10.5 bn. Fiscal deficits of the federal government, as a consequence, are set to widen by the above amount only in the upcoming fiscal years (see Chart 3)³. With respect to the future cooperation between the coalition partners, however, the current slump in tax revenues harbours considerable potential for conflict, even if the above-mentioned amount is much lower than the recent downward revisions to the tax estimates seem to suggest at first glance.

Real GDP growth rate: DB vs. federal government forecast

4



* German Stability Programme (17 April 2019)

Sources: Destatis, Eurostat, Ministry of Finance, Deutsche Bank Research

Budget surpluses are melting amid slowing growth and expansionary fiscal stance

The weaker growth outlook is already reflected in our forecasts for the general government budget (according to the Maastricht definition). We expect real GDP to edge up by only 0.7% in 2019 and 1.2% in 2020. Correspondingly, the effects from the business cycle on public finances ought to be broadly neutral this and next year. From a record high of 1.7% of GDP in 2018, the general government surplus looks set to shrink to 0.8% in 2019 and 0.5% in 2020, led by weaker growth and the government's expansionary measures which are estimated to amount to around 0.7% of GDP this year, according to the Common Joint Economic Forecasts by the German Research Institutes ("Gemeinschaftsdiagnose"). In its stability programme (of April 2019), the federal government still assumed a general government surplus of ¾% of GDP in 2019/20 (see Chart 5). These projections, however, were still based on a higher GDP forecast of 1.0% for 2019 (see Chart 4). Despite the economic downturn, the German government ought to run moderate surpluses in the years ahead, which argues for further declining debt-to-GDP ratios at the general government level. We

² At year-end 2018, the fund came to around EUR 35.2 bn (ca 1.0% of GDP).

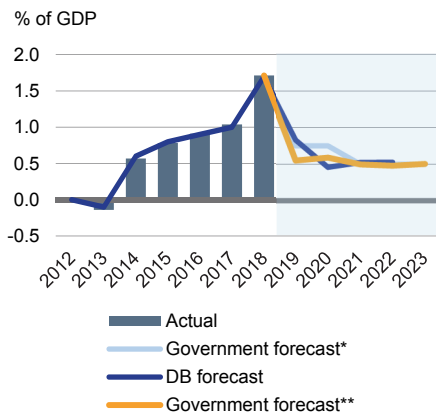
³ Tax shortfalls (relative to the March benchmark figures for the 2020 budget and the financial plan to 2023) ought to come to roughly EUR 1.6 bn in 2020, EUR 2.8 bn in 2021, EUR 2.7 bn in 2022 and EUR 3.4 bn in 2023, which means that the fiscal deficits of the federal government are likely to widen by the same amounts in the period from 2020-23 – provided no fiscal countermeasures (such as tax hikes or spending cuts) are launched.



Not out of the woods, politics of no help

General government budget surplus:
DB vs. federal government forecast

5



* German Stability Programme (17 April 2019)
** Forecast taken from the German Stability Programme but considering the latest downward revisions in the federal government's growth forecasts. Approximated using a budget semi-elasticity of 0.551 for the general government.

Sources: Destatis, Eurostat, Ministry of Finance, Deutsche Bank Research

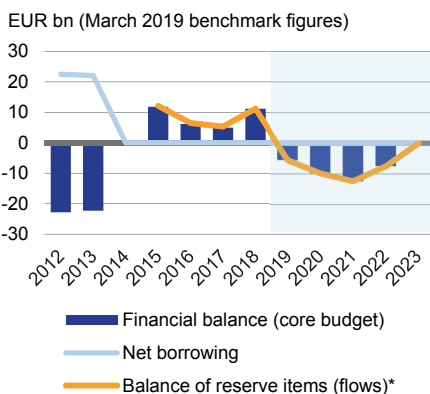
expect a further drop from 60.9% in 2018 to just 58.3% by year-end 2019 and 56.0% by year-end 2020.

Slumping tax revenues complicate adherence to the "black zero" ...

Unless tax revenues surprise to the upside (as in the preceding fiscal years when higher-than expected intake provided highly appreciated relief on a regular basis) and/or government spending is cut further, the reserve fund for refugees is unlikely to suffice to fully cover fiscal deficits as planned in the upcoming five years (see Charts 3, 6 and 7). Against this backdrop, the CDU will hardly be able to push for more meaningful tax cuts (e.g. via a complete abolition of the solidarity surcharge). By the same token, it seems highly unlikely that the SPD actually adheres to current plans and follows up on its prestige project, the basic pension for long-term earners of low wages. Contrary to the agreements in the coalition treaty, Labour Minister Heil (SPD) wants to forego a means test, which would push up costs substantially. The CDU, on the other hand, insists on a means-tested scheme. Originally, additional expenditure for the basic pension was expected to be c. EUR 5 bn per year. Without a means test, it might easily double to c. EUR 10 bn, putting further pressure on the financial planning of the federal government.

The federal gov't is planning with persistent deficits at least until 2022

6



Financial balance: Excluding payments into and withdrawals from reserves, respectively.
* only refugee reserves fund

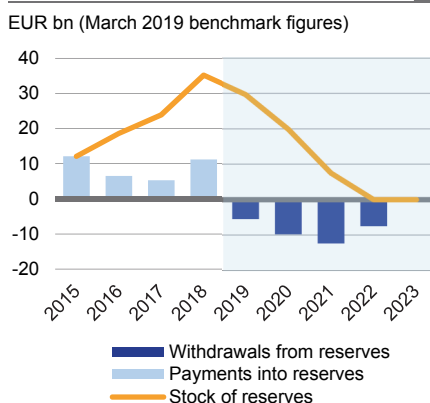
Sources: Federal Ministry of Finance, Deutsche Bank Research

... and thus harbour considerable potential for disputes over the future fiscal course of the federal government

Following the recent tax estimate, two things are clear. First, the times of fiscal surpluses are at an end now. Second, the federal government must finally define clear(er) budgetary priorities. Resolving potential conflicts by means of higher spending, as in the past, will become harder in the future, at least if the "black zero" is maintained – a fiscal goal of the Groko, which is still given priority by both CDU leaders and SPD Finance Minister Scholz, despite increasing criticism from many policymakers and economists. Recent ideas of the Federal Ministry of Labour concerning the funding of the basic pension without a means test are cause for concern, given the risk that contributors to the health scheme and the unemployment insurance will – at least in part – have to pay the bill for the federal government's costly pension scheme in times of scarce tax revenues. Should the government increasingly rely on social insurances (rather than tax subsidies, as would appear appropriate) to fund social projects, thereby using social security contributions of the employers and employees for wrongful purposes, the political credibility of the Groko, along with public trust in the sustainability of the social security system and public finances in Germany, would be dealt a severe blow.

Government plans to fully deploy the refugee reserves fund by 2022

7



Sources: Federal Ministry of Finance, Deutsche Bank Research

Exciting and pathbreaking months lie ahead of us, both in terms of the "black zero" and with respect to the coalition government in Berlin.

Sebastian Becker (+49 69 910-21548, sebastian-b.becker@db.com)

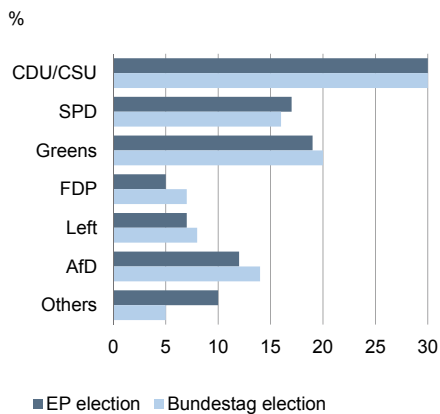


The view from Berlin

CDU and SPD – (premature) internal bickering over post-Groko politics

The Germans' preferred parties if elections were held today

1



Sources: Forschungsgruppe Wahlen, ZDF-Politbarometer, as of May 17

About two weeks ahead of important elections the Groko parties are still involved in internal debates over prominent statements from senior politicians, namely CDU party leader Annegret Kramp-Karrenbauer (AKK) and Kevin Kühnert, leader of the SPD's youth organisation. Although both politicians addressed quite different issues – the drawbacks of a carbon tax and the socialisation of big German corporations, respectively – their statements were also about their parties' future stance and perhaps (about) leadership issues. Together with Chancellor Merkel's absence in her party's EP election campaign and AKK's calling of a CDU leadership meeting on June 2-3 these debates have again triggered speculation about Merkel's imminent demission and an end of the Groko. As previously, though, we deem such speculations premature.

German politicians are already looking beyond May 26 when EP elections as well as regional elections in Bremen are held. Poor results in the EP elections, i.e. markedly less than 30% for the CDU and an SPD defeat against the Greens, though, could cause some trouble for key players. Some commentators boldly interpreted AKK's announcement of the CDU leaders' meeting as an invitation to a Merkel bashing. However, party grandees will meet to discuss the election results (as they did back in 2014) and they are also likely to formulate demands for Merkel's government and thus prepare the next meeting of the Groko parties' big shots scheduled for mid-June. At that meeting, Merkel, FM Scholz (SPD), the CDU, CSU and SPD party leaders and their Bundestag floor leaders will set the Groko's agenda for the coming months which will also see regional elections in Saxony and Brandenburg, on September 1, and in Thuringia on October 27.

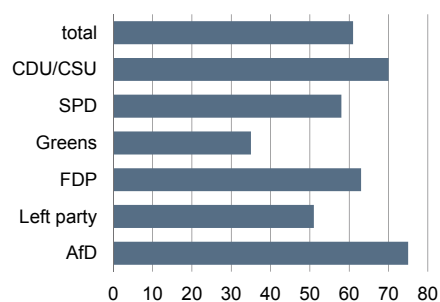
SPD: Youth calls for socialism

It is hard to tell whether it was an alleged lack of key topics in the election campaign(s), the SPD's relatively poor showing in the polls or grandstanding that provoked Kühnert to reflect publicly about collectivism and demand the nationalisation of large companies, namely BMW. While the party's more conservative wing harshly criticised him immediately, it took quite some time before SPD leader Nahles commented that one might ask the right questions while providing the wrong answers. Although Kühnert's political clout – a well-known Groko critic – should not be overrated, his statement and Nahles' lukewarm rebuttal have burdened the SPD's campaigns.

Majority of Germans refuse a carbon tax

2

Percentage of CO₂ tax critics among the supporters of the resp. party, %



Sources: Forschungsgruppe Wahlen, ZDF-Politbarometer, May 10

Länder elections could result in more disputes within the SPD

The party's mood is likely to head south especially in case the SPD loses Bremen to the CDU. Bremen is a very small city-state with only 0.48m people eligible to vote (0.8% of all voters in Germany). But the result will be highly symbolic for the SPD as the party has been running Bremen for more than 70 years. A heavy defeat would probably also burden the party's campaigns in eastern Germany. This would be especially relevant with regard to Brandenburg where the SPD-led government has no prospect of a renewed coalition with the Left party – according to the polls. Therefore, after May 26, the critics demanding the SPD to immediately leave the Groko could become more numerous and much louder.

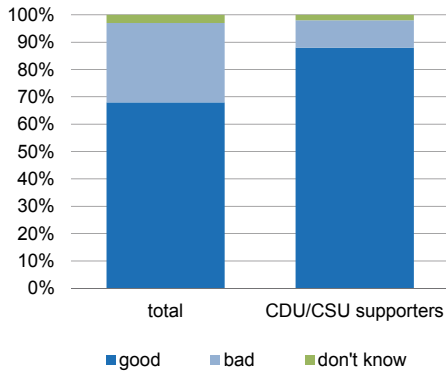


Not out of the woods, politics of no help

What the Germans think about Merkel's intention to stay in office until 2021

3

Percentage of those surveyed, %



Sources: Forschungsgruppe Wahlen, ZDF-Politbarometer, May 10

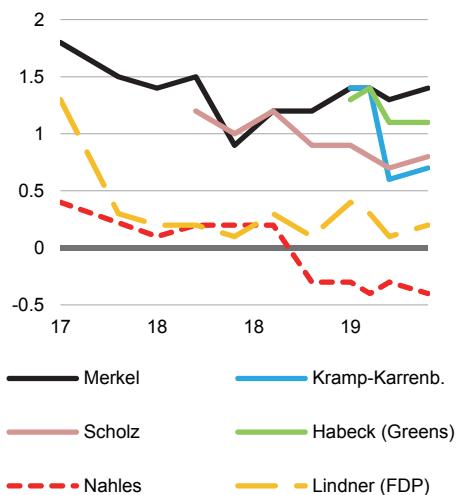
Key CDU politicians divided on carbon tax

In contrast to Kühnert's shot into the dark, AKK referred to a concrete political controversy in the current campaigns, namely to the idea of a carbon tax as ventilated by the Greens and the Social Democrats on EU (Frans Timmermans) and national level. AKK's positioning met remarkable criticism. A few weeks ago she was sitting on the fence regarding this question. Then she closed ranks with the Bavarian CSU and the CDU's conservative wing and publicly rejected such a tax, as it would increase energy prices and the cost of driving a (conventional) car and thus burden middle- and lower-income earners in particular. Meanwhile, however, CDU grandees including Ralph Brinkhaus, the CDU whip in the Bundestag, and Armin Laschet, MP in North Rhine-Westphalia and (like AKK) a potential Merkel successor, have positioned themselves against AKK and argued in favour of a more open stance. Pundits suspecting strategic reason behind this call might not be wrong, given the Greens' demands for such a tax – and their most likely decisive role in the formation of a new coalition in case the Groko fails.

Major politicians' approval ratings

4

Approval rating of the respective politician on a scale from -5 to 5



Sources: Forschungsgruppe Wahlen, ZDF-Politbarometer, May 10

Merkel likely to remain chancellor until 2021

Besides the intra-party imbroglis Merkel's move to keep a low profile in the CDU's EP election campaign (as she did in 2014) has attracted much media attention. Merkel left the stage to the CDU/CSU's front runner Manfred Weber and for AKK, the new CDU party leader. While this is comprehensible, it still triggered speculations that Merkel will soon step down as chancellor. About three weeks ago AKK unintentionally fuelled these speculations by announcing the above mentioned CDU leaders' meeting. Meanwhile the Chancellor has scotched such rumours by stating that she does not have 'surprising plans'. Thus, her statement that she is prepared to stay in office until the end of the term (in autumn 2021) still holds. Recently, AKK has taken the same line by stressing that Merkel was elected for the full term. According to a recent poll (Forschungsgruppe Wahlen), a clear majority of the Germans (68%) welcome Merkel's intention.

We also think that the public debate about Merkel's demission is at least premature. The new division of labour among the CDU's higher echelons is in line with Merkel's plan. Since December, when she resigned as party leader, Merkel more than ever has focussed on global issues and the international stage. By contrast AKK is in charge of reshaping the CDU's (domestic) political profile. So far her own standing hardly benefitted from her work. The Germans are much more satisfied with Merkel (55%; Infratest dimap) than with AKK (36%). Furthermore, at present the Groko parties face a similar situation as a soccer team after a series of defeats. The old coach will not be dismissed in order to not damage his successor when the team faces a match where it has no prospect to win. According to surveys the CDU as well as the SPD will be confronted with substantial losses in the state elections in eastern Germany in September.

Debate on loosening fiscal policy in full swing

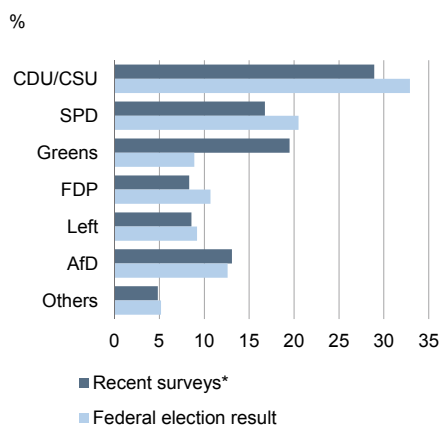
So far the SPD plans to take stock of the Groko's work and assess the prospects for enforcing further pet projects, like a basic income scheme for kids, to determine whether it will stay or leave after the elections in eastern Germany, i.e. in late autumn. In the CDU/CSU many voices have recently asked AKK to bring their own Groko mid-term review forward to the leaders' meeting on June 2 to 3. Up to now not only Merkel's present government but also its predecessor have primarily carried out social policy projects promoted by the SPD or the



Not out of the woods, politics of no help

Major political parties' popularity & result of the last federal election

5



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

Source: Wahlrecht.de, May 2019

CSU. Now especially the CDU's business wing is urging the government to prioritise the necessary enhancement of Germany as a business location. Given the subdued economic situation at present, tax relief for corporations and the complete abolishment of the income tax surcharge are seen as essential. However, according to last week's new official estimates for tax receipts, the federal government will dispose of markedly less receipts (in the amount of EUR 2.6 bn p.a. on average in the next 4 years (2020 to 2023)) than planned so far (see article on the results of the recent tax revenue estimations in this issue). This has already fuelled debates on the Groko's fiscal policy priorities and the federal government's commitment to the 'black zero', i.e. a fundamentally balanced budget. Given the less lavish public coffers, the CDU/CSU might insist on its demand for a marked downgrade of the SPD's plan for a minimum pension and its rejections of a basic income scheme for children.

Greens would gain from snap elections

The explosiveness in these debates is obvious. Given the relatively low popularity ratings, however, neither the CDU nor the SPD should be interested in breaking up the Groko. In case of possible snap elections both parties would run the risk of losing substantial numbers of seats in the Bundestag. The alternative, namely the formation of a Jamaica coalition without prior elections would be arithmetically feasible but hardly politically – for several reasons. It seems unlikely that the CDU/CSU could enact a more business oriented policy together with the Greens. Among others, the Greens advocate extended social benefits (a basic income scheme), intensified public spending on public housing and public transport among others, stricter and more restrictive environmental & climate policy (faster exit from the use of coal for power production, e.g.) and a more restrictive transport policy (from 2030 onwards no new cars with combustion engines). In addition, the Greens are likely to favour snap elections given their strong showing in the polls.

All in all there is evidence that the Groko parties could withstand weak May 26 election results and therefore would be prepared to continue their cooperation at least beyond summer. In late autumn, however, in the aftermath of the election in eastern Germany things might look different.

Barbara Böttcher (+49 69 910-31787, barbara.boettcher@db.com)
Dieter Bräuninger (+49 69 910-31708, dieter.braeuninger@db.com)

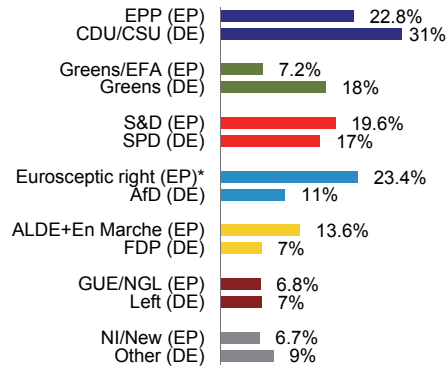


EU elections countdown: What about Germany?⁴

German parties versus their groups in the European Parliament

1

2019 EP polls for German parties compared to EP group projections, %



Note: Differing from our previous election notes, partially updated projections for the EP elections here include the UK due to the extension of Article 50 until October 2019.

*: AfD here compared to projections for all far-right Eurosceptic parties included in ENF, ECR and EFDD as

Source: DB Research Projections based on Pollofpolls.eu

Germans' view of EU more positive than Eu average

2

German views on the EU (Eurobarometer, % of respondents)

EU membership

- Would vote remain in the EU: 80% (EU28: 68%)
- Membership of the EU is a good thing: 81% (EU28: 62%)
- Supportive of EMU and euro: 81% (EU28: 62%)
- National interests accounted for in EU: 72% (EU28: 49%)
- My voice counts in the EU: 70% (EU: 51%)

EU/national elections

- Interested in May EP elections: 62% (EU28: 51%)
- Importance to vote in national elections: 79% (EU27: 68%)
- Importance to vote in EP elections: 63% (EU27: 50%)
- Very likely to vote: 48% (EU: 35%)

Trust in institutions

- National parliament: 58% (EU28: 35%)
- National government: 54% (EU28: 35%)
- EU: 51% (EU28: 42%)
- European Parliament: 60% (EU28: 48%)
- European Council: 44% (EU28: 37%)
- European Commission: 54% (EU28: 43%)
- ECB: 49% (EU28: 41%)

Sources: Standard Eurobarometer Nov 2018, Spring Eurobarometer 2019

According to current polls, the conservative CDU/CSU (31%) and the Social Democrats (17%) could lose a substantial share of votes compared to the 2014 European Parliament elections whereas the Greens (18%) and Liberals (7%) are projected to perform substantially better than in the previous round. The Greens could even overtake the SPD and become the second strongest party. Support for the far-left Leftist remains relatively unchanged at 7% while the far-right AfD could expand its share to 11%.

All major German political parties with the exception of the right-wing AfD and to some extent the Leftist party are firmly pro-European and Germany will remain a largely Europhile country. EU and euro area membership are supported by an overwhelming majority of German citizens and trust in European institutions is above EU averages.

Shifts of voters' support between centrist parties will not have a substantial impact on Germany's generally pro-European stance. However, these parties still represent diverging views on the future of the EU and increasingly feel the need to differentiate themselves from each other. When it comes to EMU deepening, SPD and Greens support French plans for risk sharing and convergence of social insurance systems on the European level while CDU/CSU and FDP are much closer to the Nordic countries which call for fiscal discipline and enforcement of the Stability and Growth Pact.

The far-right and anti-immigration AfD remains strongly Eurosceptic but has backtracked from its previous outright calls for "DEXIT". This mirrors a trend among far-right parties across the EU that now call for closer alliances to "reform" the EU from within instead of leaving it. Compared to European peers, the appeal of the AfD to German voters remains far more limited.

Recent surveys show that most candidates leading the national lists are unknown to the majority of the German electorate. Manfred Weber, the lead candidate of CDU/CSU is also EPP frontrunner to become the next Commission President. His broad electoral "guarantees" might help him find the cross-faction consensus required for a majority in the next EP but might be less effective in mobilizing conservative voters in Germany.

The outcome of the EU elections is seen as a strong indicator for this year's elections in Eastern German states and might also impact the stability of the current government coalition. The composition of the post-Merkel German government, whether following the 2021 general elections or earlier, will determine to what extent Germany will be open to further euro area deepening and broader policy collaboration.

Kevin Körner (+49 69 910-31718, kevin.koerner@db.com)

Barbara Böttcher (+49 69 910-31787, barbara.boettcher@db.com)

⁴ Executive Summary of Focus Europe. EU elections countdown #4. What about Germany?, published May 6, 2019.

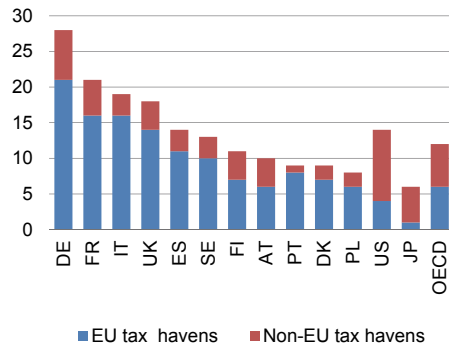


Taxing the digital economy: Good reasons for scepticism⁵

Calculated lost corporate tax revenue due to profit shifting

1

Tax losses as % of total corp. tax revenues, due to profit shifting into ..., as of 2015

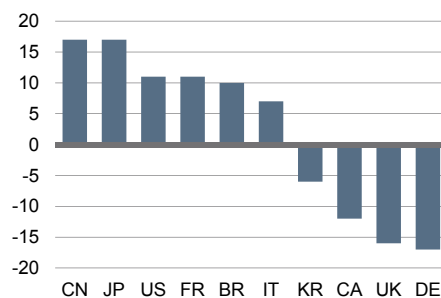


Source: Torslov, T.R. et al. (2018). The Missing Profits of Nations, NBER Working Paper, Online Appendix

Winners and losers of a corporate tax reform in the G20

2

Percentage of the relevant national tax base*, %



* selected countries, assumption that the reform follows the EU Commission's plans for a Common Consolidated Corporate Tax Base (CCCTB)

Source: German Economic Institute (IW)

Digital taxation is currently a subject of intense debate. While France, the UK, Italy, Austria and Spain have already decided to introduce a digital tax, the EU ministers of finance were unable to agree on an EU-wide system in March, which the European Commission (EC) had hoped to introduce in order to prevent looming competitive distortions and a fragmentation of the single market as each of the Member States went their own way on this issue.

However, all approaches which are based on the taxation of revenues instead of profits have major flaws. If a company is not allowed to deduct its expenses from its revenues, there will be a risk that the tax eats up corporate capital. Start-up companies with lower margins would suffer most from such a tax.

Since large digital companies are widely thought to pay inappropriately low taxes, policymakers remain under pressure to act. However, the tax gap is often exaggerated and governments themselves have created tax breaks for digital companies.

Tax experts are calling for international collaboration on this issue. The OECD's/G20's BEPS Project aims at an international solution. This initiative focuses on three major tax policy challenges caused by digital business models: 1. the global reach of business functions and activities, 2. opportunities for profit shifting due to importance of intangible assets such as licences and brands, 3. options for taxing the user contribution to digital value creation locally, i.e. in the country of destination, and not in the country where the company has its seat.

The second issue is being addressed by recent modifications in international tax law; the two others, however, require new approaches. So far, no consensus has been reached on any of the proposals on the table. For example, taxing user contributions to value creation raises tricky definition problems. What activities amount to value creation? Where does value creation really take place? How should the related profits be allocated to the different countries?

As digital services expand into ever new areas of the economy ('smart everything'), the risk of a far-reaching, arbitrary taxation of entrepreneurial activities is increasing. This might become a problem, not least for the German industry, which invests considerable sums into digitalisation.

Disruption, the buzzword of the digitalisation discussions, may become an issue in international tax policy, too. Some of the far-reaching new rules currently under discussion could certainly undermine basic principles of the current corporate taxation system.

In addition to an (international) digital tax, minimum taxes are one of the concepts under discussion. Their supporters point to elements of minimum taxation included in the recent US tax reform. However, it is still uncertain which way the international community will choose, even though a consensus is to be reached by end-2020. A reallocation of international tax revenues in favour of foreign markets might lead to Germany losing some of its share.

Dieter Bräuninger (+49 69 910-31708, dieter.braeuninger@db.com)

⁵ Executive summary of the Deutsche Bank Research EU Monitor with the same title (forthcoming).



The message from loose financial conditions in Germany

Financial Conditions Index for Germany

1

To construct the Financial Conditions Index for Germany, we take 19 indicators (see Angelopoulou, Balfoussia and Gibson (2013) for a detailed overview). These are loan flows to non-financial corporations (NFCs), loan flows to households (HHs), spread between interest rate to non-financial corporations and deposits rates to NFCs, spread between interest on overdrafts to NFCs and deposit rates to NFCs, spread between consumer loans and deposit rates to HHs, spread between mortgage loans and deposits rates to HHs, NFCs bond issuance, bank bond issuance, spread between 3 month Euribor and eonia, spread between 2 year Euribor and eonia, spread between 10 year Euribor and eonia, ECB's bank lending survey responses (BLS) to banks access to market financing, banks liquidity position, housing market prospects, consumer creditworthiness, monthly changes in VSTOXX index, mostly changes in DAX index, yoy changes in inflation, property price index. All indicators are from ECB's statistical data warehouse. Our sample covers data for Germany only apart from Euribor, euonia rates, and VSTOXX index. All variables apart from BLS questions are available at the monthly frequency from January 2003 and onwards. For BLS questions we use monthly repeated values. Finally, we demeaned and divide all indicators with their standard deviations to minimize the potential impact of outliers.

In the final sample, we pursue a principal component analysis and take the six most important factors that reflect changes in our indicators. To construct the final index, we use weights derived from the principal component analysis.

Literature: Angelopoulou, Balfoussia and Gibson (2013), "Building a Financial Conditions Index for the Euro Area and Selected Euro area Countries", ECB working paper no: 1541.

Source: Deutsche Bank Research

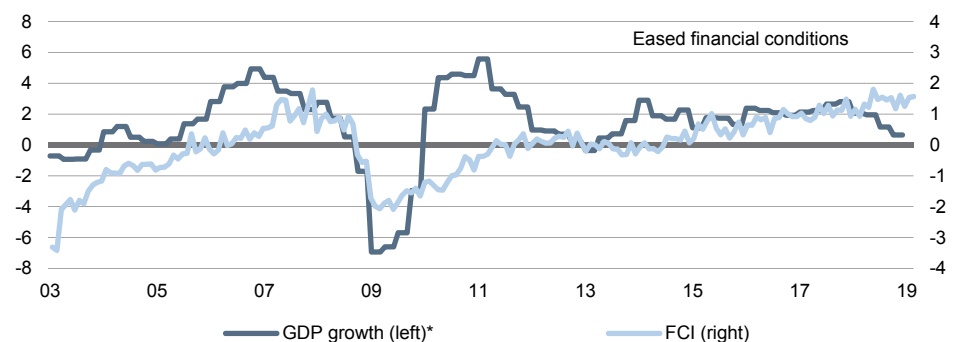
Since the start of the ECB's full-fledged quantitative easing programme in 2015, financial conditions in Germany, as measured by our Financial Conditions Index (FCI), eased persistently. Even though the stock-market decline of recent days and the intensifying trade dispute led to tightening in some underlying indicators, FCI by and large most likely remains within its long-term trend. Our index is a composite indicator of financial conditions that reflects trends in credit growth, credit spreads, equity and bond markets, bank lending conditions as well as the macro backdrop (see box for methodology and variables included). It, therefore, conveys comprehensive information compared to standard indicators such as short term interest rates, a widely used proxy of financial conditions before the prolonged rock bottom benchmark rates. FCI for Germany i) provides insights on private sector borrowing rates both at financial markets and from financial institutions that are a function of several factors beyond short term rates, ii) reflects changes in banks' risk appetite, an important indicator of credit availability over and above the cost of credit, iii) captures asset price movements as determinant of private sector wealth and future spending etc. It accordingly helps to explore macro-financial linkages and in recognition of financial stress in advance.

FCI for Germany presents three episodes since 2008: 1) significant tightening around financial crisis and years afterwards, 2) somewhat normalisation during the sovereign crisis, 3) remarkable easing since ECB's QE programme. In 2019, FCI peaked by breaching pre-crisis levels. Among the factors that support FCI have been narrowing loan spreads and lower bond spreads that cancel the somewhat negative impact of sluggish DAX performance since mid-2018. Banks meanwhile kept their lending standards largely unchanged as their access to market financing and liquidity positions were stable. Even more, they did not observe a deterioration in housing market prospects or consumer creditworthiness which probably contributed to further easing of financial conditions in Germany. Thereby, loans to non-financial firms and households saw strong net flows of EUR 23 bn and EUR 13 bn respectively in Q1- 2019. The main takeaway is that financial conditions in Germany respond to the ongoing central bank easing cycle positively.

Financial Conditions and GDP growth decouple in Germany

2

yoy left, # of standard deviations from the mean right



*repeated values within each quarter

Sources: Deutsche Bank Research, Haver Analytics

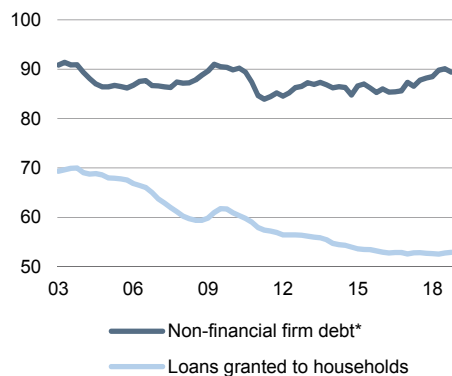


Not out of the woods, politics of no help

No evidence of excessive debt taking in Germany

3

as a ratio of GDP



*includes debt securities; loans; pension entitlements, claims of pension funds on pension managers and entitlements to non-pension benefits; trade credits and advances.

Sources: ECB, Deutsche Bank Research

What do the FCI imply for economic growth in the future in Germany? With around 45% correlation⁶ of financial conditions and economic growth is moderate, some intensification after 2013 is observable though. In line, loose FCI trend of the last 5 years went hand in hand with stable GDP growth of around 2-2.5% yoy. Since mid-2018 however, there is a decoupling between GDP growth and FCI. This might raise the question if stagnating growth will be reflected as tightening in financial conditions. A simple causality analysis⁷ between GDP growth and FCI relation reveals that it is probably not the case. While loose financial conditions might stimulate growth at least in the short term, slowed growth does not necessarily translate into tightened financial conditions.

Even though easy financial conditions is a push behind the growth in the near term, excessive credit growth together with declining lending standards and increased risk-taking might lead to a significant slowdown or even recession in the medium-term. Yet, indicators of indebtedness do not point to such behaviour in Germany. For example, loans granted to households as a ratio of GDP has been declining persistently during the last 10 years or so. Similarly, non-financial firm debt is more or less constant since 2010. Taken together loose financial conditions do not lead to excessive borrowing in Germany which might jeopardize financial stability. All in all, recent trends in FCI in Germany present a healthy backdrop where central bank monetary policy is indeed transmitted into the wider economy via loose financial conditions.

Orçun Kaya (+49 69 910-31732, orcun.kaya@db.com)

⁶ We refer to dynamic conditional correlations of a multivariate generalized autoregressive conditional- heteroskedasticity model.

⁷ In a vector autoregression (VAR) framework, we include GDP growth and demeaned FCI index as dependent variables. For the sake of simplicity, we include only lags of the dependent variables. For lag selection, we apply Akaike information criteria which points out that the optimal lag length for the model is four. To determine causality, we apply a Granger causality test after the VAR estimation.



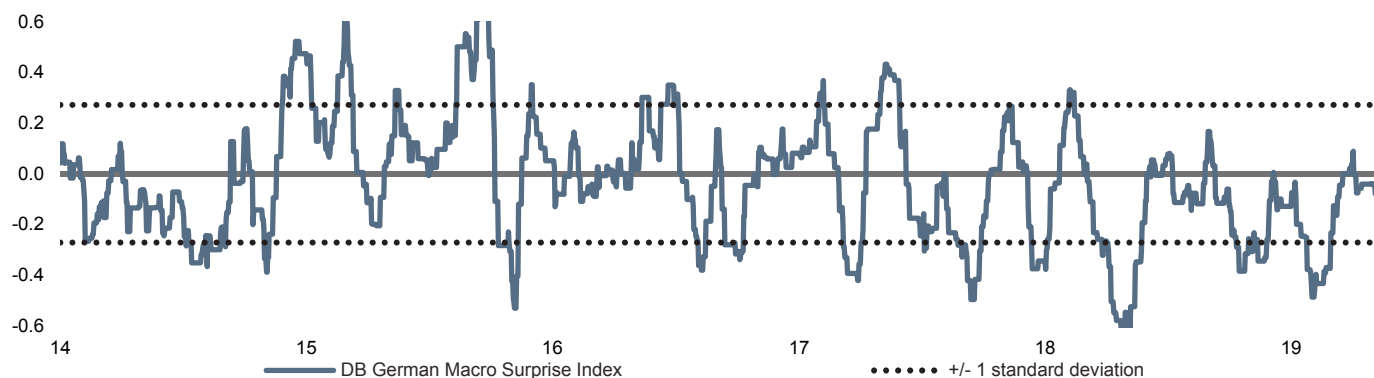
Not out of the woods, politics of no help

DB German Macro Surprise Index

The DB German Macro Surprise Index compares published economic data with market forecasts and thus provides clues as to the direction of future forecast revisions.

DB German Macro Surprise Index

Average of last 20 z-scores of data surprises



Values above (below) 0 indicate the data came in better (worse) than expected

Sources: Bloomberg Finance LP, Deutsche Bank Research

Last 20 published economic data for Germany

Bloomberg Tickers	Indicator	Reporting month	Publication date	Current value	Bloomberg consensus	Surprise	Standardised surprise	Quantile rank
GRCAEU Index	Current Account Balance (EUR bn)	2 2019	08/04/2019	17.5	19.0	-1.5	0.0	0.2
GRBTIMMM Index	Imports (% mom)	2 2019	08/04/2019	-1.6	-0.6	-1.0	-0.4	0.3
GRCP20YY Index	CPI (% yoy)	3 2019	11/04/2019	1.3	1.3	0.0	0.2	0.4
GRZEWI Index	ZEW Survey Expectations	4 2019	16/04/2019	3.1	0.5	2.6	0.4	0.7
GRZECURR Index	ZEW Survey Current Situation	4 2019	16/04/2019	5.5	8.5	-3.0	-0.5	0.2
GRUECHNG Index	Unemployment Change (000's mom)	4 2019	30/04/2019	-12.0	-7.0	5.0	0.0	0.5
GRIMP95Y Index	Import Price Index (% yoy)	3 2019	30/04/2019	1.7	2.1	-0.4	0.0	0.4
GRFRIAMM Index	Retail Sales (% mom)	3 2019	02/05/2019	-0.2	-0.5	0.3	0.5	0.7
MPMIDEMA Index	Markit Manufacturing PMI	4 2019	02/05/2019	44.4	44.5	-0.1	-0.1	0.3
MPMIDESA Index	Markit Services PMI	4 2019	06/05/2019	55.7	55.6	0.1	0.1	0.6
GRIORTMM Index	Factory Orders (% mom)	3 2019	07/05/2019	0.6	1.4	-0.8	-0.4	0.3
GRIPIMOM Index	Industrial production (% mom)	3 2019	08/05/2019	0.5	-0.5	1.0	0.9	0.8
GRTBALE Index	Trade Balance (EUR bn)	3 2019	10/05/2019	22.7	20.0	2.7	1.0	0.9
GRCAEU Index	Current Account Balance (EUR bn)	3 2019	10/05/2019	30.2	26.0	4.2	0.9	0.8
GRBTEXMM Index	Exports (% mom)	3 2019	10/05/2019	1.5	-0.4	1.9	1.0	0.8
GRBTIMMM Index	Imports (% mom)	3 2019	10/05/2019	0.4	0.5	-0.1	0.0	0.5
GRCP20YY Index	CPI (% yoy)	4 2019	14/05/2019	2.0	2.0	0.0	0.2	0.4
GRZECURR Index	ZEW Survey Current Situation	5 2019	14/05/2019	8.2	6.3	1.9	0.2	0.6
GRZEWI Index	ZEW Survey Expectations	5 2019	14/05/2019	-2.1	5.0	-7.1	-0.9	0.2
GRGDPPGQ Index	GDP (% qoq)	3 2019	15/05/2019	0.4	0.4	0.0	-0.2	0.3

Sources: Bloomberg Finance LP, Deutsche Bank Research

Updated by Sebastian Becker and Jochen Möbert (+49 69 910-31727, jochen.moebert@db.com)

Source: Heiko Peters (2014). DB German Macro Surprise Index. Focus Germany, 4 August 2014.



Not out of the woods, politics of no help

Germany: Data calendar

Date	Time	Data	Reporting period	DB forecast	Last value
23 May 2019	8:00	Real GDP (% qoq) - Details	Q1 2019	0.4	0.0
23 May 2019	9:30	Manufacturing PMI (Flash)	May	45.5	44.4
23 May 2019	9:30	Services PMI (Flash)	May	55.0	55.7
23 May 2019	10:00	ifo business climate (Index, sa)	May	100.0	99.2
29 May 2019	9:55	Unemployment rate (% , sa)	May	4.9	4.9
31 May 2019	8:00	Retail sales (% mom, sa)*	April	0.8	-0.2
31 May 2019	14:00	Consumer prices preliminary (% yoy, nsa)	May	1.6	1.4
6 Jun 2019	8:00	New orders manufacturing (% mom, sa)	April	0.5	0.6
7 Jun 2019	8:00	Trade balance (EUR bn, sa)	April	19.5	20.0
7 Jun 2019	8:00	Merchandise exports (% mom, sa)	April	-0.9	1.5
7 Jun 2019	8:00	Merchandise imports (% mom, sa)	April	0.2	0.4
7 Jun 2019	8:00	Industrial production (% mom, sa)	April	0.3	0.3

*An earlier data release may be possible due to the Federal Statistical Office.

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

Marc Schattenberg, Sebastian Becker & Jochen Möbert (+49 69 910-31727, jochen.moebert@db.com)



Not out of the woods, politics of no help

Financial Forecasts

	US	JP	EMU	GB	CH	SE	DK	NO	PL	HU	CZ
Key interest rate, %											
Current	2.375	-0.10	0.00	0.75	-0.75	-0.25	0.05	1.00	1.50	0.16	2.00
Jun 19	2.375	-0.10	0.00	0.75	-0.75	-0.25	0.05	1.00	1.50	0.30	2.00
Sep 19	2.375	-0.10	0.00	1.00	-0.75	-0.25	0.05	1.00	1.50	0.25	2.00
Dec 19	2.375	-0.10	0.00	1.00	-0.50	0.00	0.20	1.25	1.50	0.25	2.00

3M interest rates, %

Current	2.53	0.05	-0.31	0.80
Jun 19	2.55	0.05	-0.33	1.00
Sep 19	2.50	0.05	-0.30	1.13
Dec 19	2.70	0.05	-0.30	1.13

10Y government bonds yields, %

Current	2.39	-0.05	-0.11	1.05
Jun 19	2.45	0.05	0.20	1.65
Sep 19	2.40	0.05	0.35	1.70
Dec 19	2.40	0.05	0.40	1.73

Exchange rates

	EUR/USD	USD/JPY	EUR/GBP	GBP/USD	EUR/CHF	EUR/SEK	EUR/DKK	EUR/NOK	EUR/PLN	EUR/HUF	EUR/CZK
Current	1.12	109.94	0.88	1.28	1.13	10.77	7.47	9.75	4.31	326.38	25.75
Jun 19	1.16	110.00	0.84	1.38	1.13	10.60		9.70	4.35	320.00	25.70
Sep 19	1.10	107.50	0.93	1.18	1.14	10.70		9.65	4.35	321.50	25.60
Dec 19	1.13	105.00	0.93	1.22	1.15	10.80	7.46	9.60	4.35	323.00	25.50

Sources: Bloomberg Finance LP, Deutsche Bank Research



Not out of the woods, politics of no help

German data monitor

	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Nov 2018	Dec 2018	Jan 2019	Feb 2019	Mar 2019	Apr 2019
Business surveys and output											
Aggregate											
Ifo business climate	102.5	103.4	102.1	99.3		102.3	101.2	99.6	98.7	99.7	99.2
Ifo business expectations	98.9	99.9	98.5	94.8		98.7	97.3	94.8	94.0	95.6	95.2
Industry											
Ifo manufacturing	105.2	104.6	101.6	97.8		101.9	100.6	98.9	97.8	96.7	95.4
Headline IP (% pop)	0.3	-1.4	-1.1	-0.1		-1.1	0.7	-0.3	0.1	0.3	
Orders (% pop)	-1.3	-1.0	0.5	-4.1		-0.7	1.0	-2.1	-4.0	0.6	
Capacity Utilisation	87.8	87.8	87.1	86.3	85.3						
Construction											
Output (% pop)	5.8	-0.1	-1.0			-0.9	-1.4	-1.0	13.4		
Orders (% pop)	-5.2	0.7	11.3			6.1	13.2				
Ifo construction	111.7	116.4	116.8	111.3		116.3	116.1	111.6	110.6	111.8	112.4
Consumer demand											
EC consumer survey	-1.1	-1.5	-1.5	-2.2		-1.1	-2.3	-2.3	-2.2	-2.0	-2.7
Retail sales (% pop)	1.7	-0.6	0.7	1.6		1.6	-3.0	2.9	0.5	-0.2	
New car reg. (% yoy)	1.9	1.2	-8.1	0.2		-9.9	-6.7	-1.4	2.7	-0.5	-1.1
Foreign sector											
Foreign orders (% pop)	-1.1	-2.2	0.9	-5.2		-3.2	1.5	-2.6	-5.8	4.2	
Exports (% pop)	1.0	-0.2	0.9	0.8		-0.1	1.5	0.1	-1.2	1.5	
Imports (% pop)	2.1	2.3	-0.1	0.5		-1.3	0.6	1.4	-1.6	0.4	
Net trade (sa EUR bn)	59.6	52.7	56.1	57.4		18.7	19.8	18.6	18.7	20.0	
Labour market											
Unemployment rate (%)	5.2	5.2	5.0	5.0		5.0	5.0	5.0	5.0	4.9	4.9
Change in unemployment (k)	-39.7	-36.3	-45.7	-32.7		-16.0	-13.0	-3.0	-20.0	-7.0	-12.0
Employment (% yoy)	1.3	1.2	1.2	1.1		1.2	1.2	1.1	1.1	1.1	
Ifo employment barometer	104.0	104.8	104.2	102.5		103.7	104.1	103.0	102.8	101.6	101.5
Prices, wages and costs											
Prices											
Harmonised CPI (% yoy)	2.0	2.2	2.2	1.6		2.2	1.7	1.7	1.7	1.4	2.1
Core HICP (% yoy)	1.3	1.4	1.4	1.5		1.1	1.2	1.8	1.6	1.0	1.9
Harmonised PPI (% yoy)	2.6										
Commodities, ex. Energy (% yoy)	2.6	-0.5	-0.3	1.5		-0.1	-2.2	-2.3	2.9	3.7	4.2
Crude oil, Brent (USD/bbl)	74.5	75.1	68.0	63.1		64.7	56.5	59.4	64.0	66.1	71.2
Inflation expectations											
EC household survey	17.3	21.4	21.5	19.0		21.2	21.9	20.1	19.1	17.7	19.9
EC industrial survey	13.8	15.8	17.6	14.4		17.3	21.1	18.9	13.0	11.4	6.7
Unit labour cost (% yoy)											
Unit labour cost	1.7	3.4	2.7								
Compensation	2.9	3.5	2.8								
Hourly labour costs	1.6	3.0	2.0								
Money (% yoy)											
M3	3.6	4.1	4.5	5.1		4.4	4.5	4.0	4.4	5.1	
M3 trend (3m cma)						4.3	4.5	4.3	4.3	4.5	
Credit - private	4.3	4.3	3.9	4.1		3.8	3.9	3.7	3.9	0.0	
Credit - public	-7.0	-2.7	-6.3	14.1		-6.4	-6.3	-9.0	-1.4	14.1	

% pop = % change this period over previous period.

Source: Deutsche Bundesbank, European Commission, Eurostat, Federal Employment Agency, German Federal Statistical Office, HWWI, ifo, IHS Markit



Focus Germany

Our publications can be accessed, free of charge, on our website www.dbresearch.com. You can also register there to receive our publications regularly by E-mail.

Ordering address for the print version:

Deutsche Bank Research
Marketing
60262 Frankfurt am Main
Fax: +49 69 910-31877
E-mail: marketing.dbr@db.com

Available faster by E-mail:
marketing.dbr@db.com

- ▶ Not out of the woods, politics of no help May 20, 2019
- ▶ Exports and autos weigh heavily on the German economy in 2019 April 4, 2019
- ▶ The German economy's Achilles heel March 4, 2019
- ▶ The R-question February 5, 2019
- ▶ Outlook 2019:
Slowing growth, but no hard landing December 14, 2018
- ▶ 2019: Only 1.3% GDP growth,
snap elections a distinct possibility November 4, 2018
- ▶ Increasing headwinds but fiscal surplus (still) rising ... October 4, 2018
- ▶ Clouds on the horizon for Goldilocks September 4, 2018

© Copyright 2019. Deutsche Bank AG, Deutsche Bank Research, 60262 Frankfurt am Main, Germany. All rights reserved. When quoting please cite "Deutsche Bank Research".

The above information does not constitute the provision of investment, legal or tax advice. Any views expressed reflect the current views of the author, which do not necessarily correspond to the opinions of Deutsche Bank AG or its affiliates. Opinions expressed may change without notice. Opinions expressed may differ from views set out in other documents, including research, published by Deutsche Bank. The above information is provided for informational purposes only and without any obligation, whether contractual or otherwise. No warranty or representation is made as to the correctness, completeness and accuracy of the information given or the assessments made.

In Germany this information is approved and/or communicated by Deutsche Bank AG Frankfurt, licensed to carry on banking business and to provide financial services under the supervision of the European Central Bank (ECB) and the German Federal Financial Supervisory Authority (BaFin). In the United Kingdom this information is approved and/or communicated by Deutsche Bank AG, London Branch, a member of the London Stock Exchange, authorized by UK's Prudential Regulation Authority (PRA) and subject to limited regulation by the UK's Financial Conduct Authority (FCA) (under number 150018) and by the PRA. This information is distributed in Hong Kong by Deutsche Bank AG, Hong Kong Branch, in Korea by Deutsche Securities Korea Co. and in Singapore by Deutsche Bank AG, Singapore Branch. In Japan this information is approved and/or distributed by Deutsche Securities Inc. In Australia, retail clients should obtain a copy of a Product Disclosure Statement (PDS) relating to any financial product referred to in this report and consider the PDS before making any decision about whether to acquire the product.

Printed by: HST Offsetdruck Schadt & Tetzlaff GbR, Dieburg

ISSN (Print) 2510-5248 / ISSN (Online) 2512-0824