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Focus Germany

The brave new world of monetary policy

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Germany: 2013 GDP forecast lowered to 0.1%. Even though our forecast for German GDP growth in 2013 has hugged the lower end of the consensus range for quite a while, we have slightly reduced our estimate to 0.1% (from 0.3%). The main reasons for doing so are the below-forecast Q1 GDP reading (0.1% qoq) and the downward revision for 2012, which additionally depressed the starting level for 2013. In spite of a weather-related catch-up effect in Q2 we look for a rather moderate recovery in the course of the year, especially since the global economy is still not offering much support. There are signs of the economy bottoming out in the eurozone, but the recession has still not relaxed its grip. While we have boosted our GDP forecast for Japan from 1.4% to 2.1%, we have cut our estimate for China from 8.2% to 7.8% at the same time. The recovery in the United States is continuing apace, but positive and negative surprises are still more or less cancelling each other out.

The 2013 pay round: Major increase in real terms. Despite the downward revision to German GDP we now expect private consumption to pick up by 1%. The driving factors are the high employment level, falling inflation and relatively robust wage settlements. Following the settlements in the metal-working and electrical engineering industries the overall economy is set for wage growth of around 3%. While this slightly exceeds the distribution-neutral scope, it is generally still a reasonable level, even though unit labour costs are likely to increase by about 2 to 2 ½% in the current year.

The brave new world of monetary policy. In an article with more of a structural bent we address the “brave new world” of monetary policy. Before the global financial and economic crisis erupted central bankers were considered if not the masters of the universe at least the masters of the world of finance. However, serious problems have emerged with regard to both the theoretical underpinnings of monetary policy as well as to its implementation. As the roles of the financial sector and asset bubbles had been neglected, the problems contributed to the development of the global financial crisis. The – probably in some cases unavoidable – compromises made on the division of labour between monetary and fiscal policy and on the deployment of monetary instruments in the drive to manage the crisis have raised doubts about central banks’ independence. New tasks in the supervision and regulation of the financial industry as well as the considerable distribution effects of their anti-crisis policy are likely to bring the central banks even further into the sphere of political influence, with corresponding risks to their independence. This issue is followed watchfully by critics in Germany in particular.

Economic forecasts

	Real GDP (% growth)			Consumer Prices* (% growth)			Current Account (% of GDP)			Fiscal Balance (% of GDP)		
	2012	2013F	2014F	2012	2013F	2014F	2012	2013F	2014F	2012	2013F	2014F
Euroland	-0.6	-0.6	1.0	2.5	1.6	1.6	1.3	1.7	1.6	-3.7	-3.0	-2.5
Germany	0.7	0.1	1.5	2.0	1.4	1.6	7.0	7.0	6.9	0.2	-0.3	-0.1
France	0.0	-0.6	1.1	2.2	1.4	1.5	-2.3	-2.2	-1.9	-4.8	-3.8	-3.3
Italy	-2.4	-1.8	0.9	3.3	1.8	1.6	-0.5	0.0	0.4	-3.0	-3.5	-3.0
Spain	-1.4	-1.6	0.5	2.4	1.9	1.3	-1.1	0.5	0.3	-10.6	-6.6	-5.8
Netherlands	-1.0	-0.5	0.8	2.8	2.6	1.7	9.9	8.2	8.0	-4.1	-3.8	-3.0
Belgium	-0.3	-0.3	1.0	2.6	1.4	1.6	-1.4	0.5	1.0	-3.9	-3.0	-3.0
Austria	0.8	0.8	1.6	2.6	2.3	2.0	1.8	2.2	2.4	-2.5	-2.3	-2.1
Finland	-0.2	-0.3	1.0	3.2	2.3	2.2	-1.8	-0.8	-1.0	-1.9	-2.3	-1.8
Greece	-6.4	-4.5	0.5	1.0	-0.3	-0.1	-3.4	-2.0	-1.0	-10.0	-4.9	-3.7
Portugal	-3.2	-2.2	0.8	2.8	0.5	1.2	-1.8	1.0	1.5	-6.4	-5.6	-4.4
Ireland	0.9	0.5	1.7	1.9	1.2	1.4	4.9	3.5	4.0	-7.6	-7.7	-5.5
UK	0.3	0.5	1.8	2.8	3.0	2.6	-3.7	-3.1	-2.5	-7.8	-7.1	-6.4
Denmark	-0.5	0.3	1.5	2.4	2.0	2.0	5.5	5.0	4.5	-4.4	-2.5	-2.0
Norway	3.0	2.2	2.6	0.7	1.8	2.0	14.2	14.0	13.0	10.1	10.5	10.0
Sweden	1.1	1.3	2.3	0.9	1.0	1.5	6.9	6.5	6.0	-0.7	-0.5	0.0
Switzerland	1.0	1.0	1.5	-0.7	0.2	0.6	13.6	10.5	10.0	0.3	0.5	0.5
Czech Republic	-1.2	0.7	2.8	3.3	2.0	2.0	-2.4	-2.3	-2.4	-4.4	-3.2	-2.7
Hungary	-1.7	-0.2	1.6	5.7	2.6	3.1	1.6	1.2	0.5	-2.0	-2.7	-2.6
Poland	1.9	1.3	2.3	3.7	1.3	2.2	-3.5	-2.3	-3.0	-3.9	-3.6	-3.3
United States	2.2	2.2	3.2	2.1	2.1	2.6	-3.1	-3.2	-3.4	-6.9	-5.2	-3.6
Japan	2.0	2.1	0.8	0.0	-0.1	2.2	1.1	1.1	2.2	-9.6	-9.5	-7.7
World	2.9	3.1	4.0	3.3	3.2	3.6						

*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

						2012				2013			
	2010	2011	2012	2013F	2014F	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F
Real GDP	4.2	3.0	0.7	0.1	1.5	0.6	0.2	0.2	-0.7	0.1	0.5	0.3	0.3
Private consumption	0.9	1.7	0.8	1.0	1.0	0.4	0.1	0.1	-0.3	0.8	0.3	0.4	0.3
Gov't expenditure	1.7	1.0	1.2	0.3	0.6	0.5	-0.4	0.7	0.1	-0.1	0.1	0.1	0.1
Fixed investment	5.9	6.2	-2.5	-1.7	3.1	-0.9	-1.9	-0.4	-1.1	-1.5	1.7	0.4	0.6
Investment in M&E	10.3	7.0	-4.8	-3.2	4.0	-1.1	-3.0	-2.2	-2.0	-0.6	0.3	0.5	1.0
Construction	3.2	5.8	-1.5	-0.2	2.3	-0.6	-1.4	0.5	-0.7	-2.1	3.0	0.3	0.3
Inventories, pp	0.6	0.2	-0.4	0.0	0.0	-0.2	-0.1	-0.3	0.4	-0.1	0.0	0.0	0.0
Exports	13.7	7.8	3.8	0.7	6.5	1.2	3.1	1.4	-2.4	-1.8	2.0	2.0	2.3
Imports	11.1	7.4	2.2	1.1	6.8	-0.2	2.3	0.6	-1.3	-2.1	2.2	2.3	2.7
Net exports, pp	1.7	0.6	0.9	-0.1	0.3	0.7	0.6	0.4	-0.7	0.1	0.1	0.0	0.0
Consumer prices*	1.1	2.1	2.0	1.4	1.6	2.1	1.9	2.0	2.0	1.5	1.3	1.4	1.5
Unemployment rate, %	7.7	7.1	6.8	6.9	6.7	6.8	6.8	6.8	6.9	6.9	6.9	7.0	6.9
Budget balance, % GDP	-4.1	-0.8	0.2	-0.3	-0.1								
Balance on current account, % GDP	6.2	6.2	7.0	7.0	6.9								

*Inflation data for Germany based on national definition. This can lead to discrepancies to other DB publications.
Sources: Federal Statistical Office, DB Research

Germany: 2013 GDP forecast lowered to 0.1%

— Although the 0.1% increase in Q1 GDP was confirmed, details and the downward revision to Q4 point to a lower annual average.

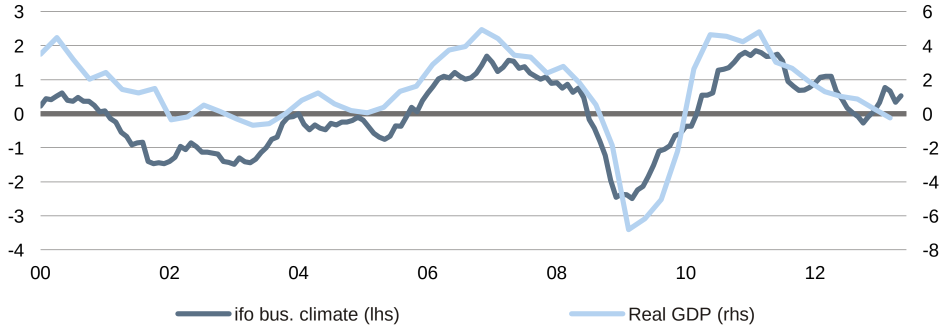
— Our new quarterly forecast calls for a weather-related rebound to 0.5% qoq in Q2, followed by 0.3% rates for Q3 and Q4, which are dependent on external tailwinds in H2.

— This fits to the May reading of the ifo index. At 105.7 (April 104.4) it was clearly above consensus, but the improvement was confined to the assessment of the current situation (110.0 after 107.3), while expectations remained at 101.6.

Q1 details: The detailed GDP release confirmed the first estimate: GDP expanded by 0.1% qoq (-1.4% yoy), with private consumption (+0.8%) being the single clear growth contributor. Net-exports still mustered a 0.1%-point contribution to growth. The 6 quarter decline in investment spending seems to taper off (-0.6% qoq), while construction (-2.1%) was hit by the harsh winter weather. Still, our quarterly models based on monthly indicators suggest a slightly higher growth rate of 0.3% to 0.4% for Q1, so there might be some potential for an upward revision, which, however, is unlikely to materialize this year. The 1.4% contraction in yoy-rate of GDP following stagnation in Q4 is largely the result of a negative calendar effect, calendar adjusted the drop was 0.2%.

Real GDP growth & ifo 1

Germany; standardized values (lhs); % yoy (rhs)

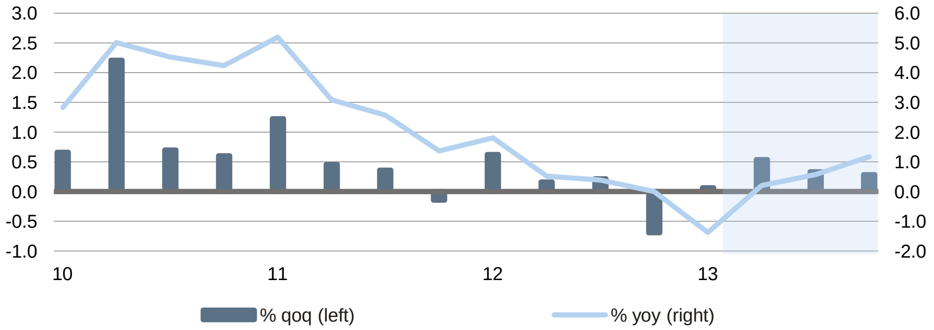


Sources: Federal Statistical Office, Markit, ifo, DB Research

Quarterly profile in 2013: Our models based on different components of the ifo index now point to around ½% GDP expansion in Q2. While this might look a little high, it makes sense when taking the likely weather related rebound in construction output into account. For H2 we expect quarterly growth rates in line with the potential rate of 0.3%, which on top of stable domestic demand does require some support from a reviving world economy.

Germany: Real GDP growth 2

% qoq, sa (left); % yoy, nsa (right)



Sources: Federal Statistical Office, DB Research

Composition: The favourable income situation for private households prompted us to lift our private consumption forecast for 2013 to 1% (from 0.7%), although the impressive 0.8% increase in private consumption followed a downward revised 0.3% drop in Q4. However, while gross and net-wages per employee expanded a healthy 3.6% (yoy) or 2.1% in real terms in Q1, disposable income expanded a meagre nominal 0.5%, resulting in a real drop of 1%. These low numbers are partly due to basis effects. In addition, profits and interest income received by private households accounting for 36% of their disposable income suffered a 3.2% yoy decline (-0.6% in Q4). Finally, social transfers were probably also rather weak in Q1. Still, record employment, solid wage increase of around 3% and a very modest inflation rate should contribute to positive development of disposable income and private consumption throughout the year.

Even if investment spending (machinery & equipment) stops its 6 quarter decline and turns positive in Q2, the annual average will remain negative at around -3%. The renewed decline in profit and interest income (3.8% after 4.4%, yoy) – reflecting a 4.1% increase in unit labour costs (hourly concept) –, however, does together with the muted expectations expressed in the ifo business climate not seem to provide the backdrop for a stronger rebound in investment. The sharp export contraction in the winter half (Q4 -2.4%, Q1 -1.8%) results in a downward revision of our annual export growth number to 0.7%. Net-exports will probably subtract 0.1 %-points from this year's growth after contributing a full percentage point last year.

Risks – still to the downside: Although we have already been at the bottom of the consensus for quite some time, the 0.2 percentage point downward revision (which is still far smaller than the usual margin of error in annual GDP fore-casts), does still make our forecast an optimistic one, which can be clearly seen in the quarterly profile. Unless, we get an upward revision for Q1 over the next quarters, risks are still skewed to the downside.

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The 2013 pay round: Major increase in real terms

The 2013 pay round, in which new collective agreements are being negotiated for a total of more than 12 million employees, has probably peaked with the settlement in the metal and electrical industry. When agreement could not be reached in Baden-Württemberg despite the two sides drawing much closer together, the Bavarians took over and relatively quickly reached a settlement providing for an average pay increase of 3.1% for 2013 and 2014 that was in line with expectations. Volkswagen, which has its own collective wage agreement, adopted the IG-Metall settlement but topped it with a EUR 300 one-off contribution to pension plans or alternatively a EUR 275 addition to the August wage payment. Given the IG-Metall union's initial demands (a 5.5% increase for 12 months), the settlement should be regarded as something of a success for the employers, not least because it runs for an extended period until the end of 2014. This came, however, at the expense of employers sacrificing the inclusion of "opening clauses" that would have allowed for deviations from the terms of the collective agreement. In view of the uncertainty concerning the economy and very diverging developments across the industrial sectors, we expect the metal industry to boost output by 1½% this year.

With output and employment trending sideways the settlement is likely to result in unit wage costs rising by 2-2½%. This assumes that the companies utilise the working time flexibility agreed in previous settlements and – in cases of hardship – also make greater use of short-time working.

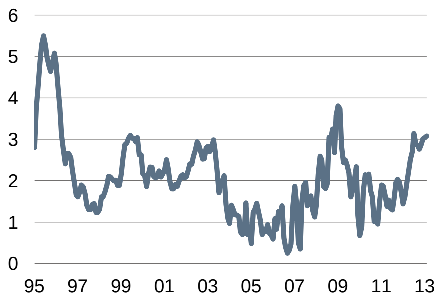
Settlements in H1 mostly around the 3% level

To date, negotiated settlements have been concluded for more than 5.6 million workers. The 2013 pay round has thus nearly reached the halfway stage. The going rate for this year's new settlements is a pay increase of about 3%. Wages for the 600,000-plus employees in the construction sector, for example, will rise from May by 3.2% (in west Germany) and by 4% (in east Germany). Recently the two sides at Deutsche Post AG also agreed on a significant pay rise for the 100,000-plus employees. The 5.7% increase quoted most frequently in the press will, however, be paid in two stages (3.1% from August 2013 and a further 2.6% from October 2014), which puts the big headline figure into perspective.

Settlements above the 3% average have been reached in the hotel and catering sector (+4%) and agriculture (+3.7%). In both sectors, however, the workforce of over 100,000 is smaller than that in the construction sector with in excess of 600,000 employees. A slightly lower-than-average settlement was reached for civil-service staff at the *Länder* level (over 800,000 employees), with increases of 2.65% for 2013 and 2.95% for 2014.

Wage increase in H2 2012 of around 3% 1

Collectively agreed wages, incl. all ancillary agreements, hourly basis, % yoy, 3M mov. avg.



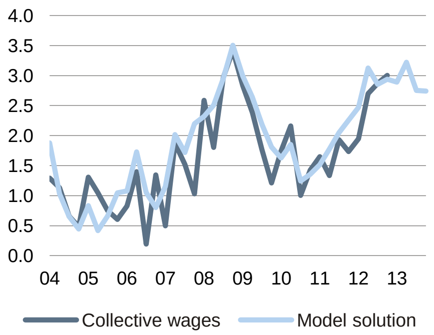
Source: Deutsche Bundesbank

2013: Collective hourly wages likely to rise by 3%

The existing collective agreements and demands in the first half of this year suggest that the pay round in 2013 will probably yield an average wage increase of about 3%. The development of hourly wages actually paid in the economy as a whole in the current year is not only dependent on the newly signed settlements. There is also a knock-on effect from last year's collective agreements. In this respect the 2013 pay round appears to be carrying on exactly where H2 2012 left off. During that period many settlements delivered pay rises of 3% or more and the collective wage index rose by 2.9% yoy (collective hourly wages incl. all ancillary agreements) compared with just 2.3% in H1. Conversely, the pay rises agreed in the current year will be granted in most cases in the middle of 2013 at the earliest, which limits the effect on this year's pay increase. In addition, a part is also played by ancillary agreements such as bonuses and one-off payments, holiday pay and also the raising of wage floors. Last but not least, non-monetary agreements are often also incorporated in collective agreements. Although these non-monetary agreements do not influence the collective wage index they can nevertheless significantly benefit employees and employers by, for example, providing an employment guarantee in return for a collectively agreed greater degree of flexibility at the individual company level.

Hourly wages up 3% according to model 2

Collectively agreed wages, incl. all ancillary agreements, hourly basis, % yoy



Sources: Federal Statistical Office, Deutsche Bundesbank, DB Research

The increase in collective wages of around 3% is also backed by our model that forecasts an increase of 2.9%. This figure is slightly higher than when we last updated our model at the start of April[1], which is a result of the extension of the observation period, the integration of the latest data from the end of 2012 and the re-estimation of the regression coefficients. The model explained roughly 70% of the fluctuation in the wage index in the past. It is based on the assumption that productivity growth and core inflation feed through to wages with a time-lag. On top of this, there is current unemployment, which impacts the negotiating position of the unions/employees. The current development in these indicators suggests that, according to our model, wages will pick up again slightly in 2013. In 2012 the increase came to 2.7% and in 2011 it was 1.5%. The chart shows, however, that wage growth towards the end of 2013 could turn out to be slightly more moderate. This will be caused by the sharp slowdown in productivity growth at end-2012, a phenomenon that usually feeds through to wages with a time-lag.

2013 pay round: Settlements to date mostly above 3% 3

Selected settlements and demands of the 2013 pay round

Sector	Expires	Pay settlement	Demand	Number of employees
Construction	30.04.2013	3.2% (west Germany) / 4.0% (east Berlin, east Germany) from 1.5.2013	6.60%	644,200
Deutsche Bahn AG	31.07.2014	3% from 1.5.2013 and 3% from 1.4.2014	6.50%	134,000
Deutsche Post AG	31.05.2015	3.1% from 1.8.2013 and 2.6% from 1.10.2014	6.00%	132,000
Retail	-	-	6.50%	463,300
Iron and steel industry	31.05.2014	3% from 1.3.2013	5.00%	85,300
Hotel and catering sector in Bavaria	31.07.2014	4% from 1.4.2013	EUR 120	127,800
Industrial cleaning segment	-	-	-	381,200
Agriculture	30.06.2015	3.7% from 1.3.2013 and 2.8% from 1.7.2014	-	154,000
Metal and electrical industry	31.12.2014	3.4% from 1.7.2013 and 2.2% from 1.5.2014	5.50%	3,443,300
Länder public sector	31.12.2014	2.65% from 1.1.2013 and 2.95% from 1.1.2014	6.50%	822,700
Private transport and traffic sector	31.05.2014	2.8% from 1.6.2013	-	149,000
Temporary employment	-	-	Lowest pay group from EUR 8.19 to 8.50	890,000

Source: WSI-Tarifarchiv (as of May 7)

High increase in real terms thanks to low inflation

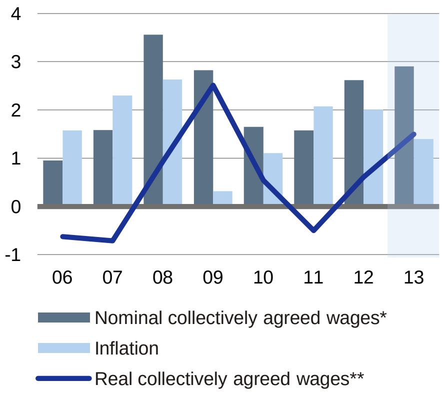
In real terms the 2013 pay round is turning out to be very satisfactory for employees: the inflation rate is likely to fall to an average of 1.4% this year (compared with 2% in 2012) and thus be about half a percentage point lower than forecasted at the start of the year (Consensus Economics January 1.9%). All in all, collective hourly wages in 2013 should increase appreciably in real terms by 1.5% compared with 0.6% last year.

Of course the wage increase for employees means at the same time higher costs for companies. With pay rises that exceed productivity growth and the

[1] See Focus Germany: Sentiment indicators – another setback in spring. April 2, 2013.

2013: Wage growth high; inflation rate down 4

% yoy



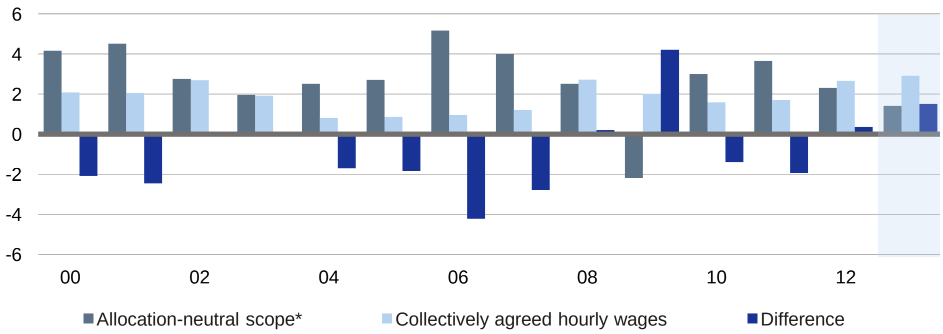
*Collectively agreed hourly wages, incl. all ancillary agreements
**Nominal wage growth minus inflation

Sources: Federal Statistical Office, DB Research

increase in selling prices (approximated by the inflation rate), the danger exists that a company's competitive and profit situation deteriorates to such an extent that it lays off personnel. That is why an allocation-neutral pay policy is often recommended in which the maximum pay increase may amount to the total of productivity growth and the increase in prices. Given that compared with our latest estimate we expect wages to be slightly higher and productivity to be slightly lower[2] the pay increase exceeds the allocation-neutral scope in 2013 even somewhat more clearly. Given the tendency towards under-utilisation over the last 10 years, the also cyclically driven over-utilisation in the current year is probably justifiable. The minimal overall impact should tend to be reflected in weaker corporate profits rather than in job cuts. Should, however, a more pronounced economic upturn not materialise during 2013 and 2014, companies could react by adjusting their staffing levels.

Allocation-neutral scope in 2012 and 2013 moderately over-exhausted 5

Hourly basis, nominal, % yoy



* Inflation rate + productivity growth

Sources: Federal Statistical Office, DB Research

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[2] See Focus Germany: Sentiment indicators – another setback in spring April 2, 2013.

The brave new world of monetary policy

— In the twenty years leading up to the global financial and economic crisis, monetary policy in the industrial countries appeared to have reached its nirvana. Several central bankers had obtained cult status, with one of the main driving factors being the “Great Moderation”, and even if they were not the masters of the universe at least they were considered as such in the world of finance.

— However, in retrospect, serious problems have emerged with regard to both the theoretical underpinnings of their monetary policy as well as to its implementation. As the roles of the financial sector and asset bubbles had been neglected, the problems contributed to the development of the global financial crisis.

— The – probably in some cases unavoidable – compromises made on the division of labour between monetary and fiscal policy and on the deployment of monetary instruments in the drive to manage the crisis have raised doubts about central banks’ independence. Additional tasks in connection with the supervision and regulation of the industry as well as the huge distribution effects of their anti-crisis policy are likely to bring the central banks even further into the sphere of political influence, with corresponding risks to their independence.

The financial and economic crisis refuses to die down, and this has sparked critical analysis of the relationship between markets and governments as a consequence. Scrutiny focuses on the role of the financial industry in particular. Monetary policy is increasingly also coming under fire. Critics are asking questions not only about its role in triggering the financial and economic crisis, but increasingly also about its role in crisis management and the democratic legitimacy of the action being taken by its makers. Bundesbank President Jens Weidmann, for example, does not mince words when discussing the risks to central banks’ independence. His counterpart at the Federal Reserve Bank of St. Louis, James Bullard, sees the consensus on the wisdom of central bank independence weakening and speaks of “the creeping politicization” of monetary policy[3].

In the following we shall discuss the monetary paradigm that prevailed in the 25 years before the financial crisis and how its weaknesses contributed to the financial crisis. In the second and third sections we analyse how the role of the central banks in dealing with the financial crisis has changed and, in this regard, to what extent this harbours risks for their political independence.

The good old days …

Following the focusing of monetary policy on capping inflation, as propounded by Milton Friedman and implemented by Fed Chairman Paul Volcker, it was increasingly realised that monetary action had to be timely and rather technocratic in its application and that it was thus best delegated to an independent institution. While many understood this to be the final stage – more or less the nirvana – of monetary policy, there were also voices saying that independent central banks should be regarded as a historic exception.[4]

3 The Global Battle Over Central Bank Independence. James Bullard. January 4, 2013.
4 David Cobham. The past, present, and future of central banking. Oxford Review of Economic Policy. Volume 28, Number 4, 2012, pp. 729-749.

The Taylor principle[5] developed in 1993 has become virtually the essence of the monetary paradigm over the past 20 years. The monetary policy achievements based on it appeared to deliver proof that a credit-based system functions better when it is free from the direct influence of government. One key aspect in this context is that independent central banks were no longer prepared to fund public-sector budget deficits; they were also against funding them indirectly via overly generous monetary policy. This means that the fiscal policy leeway was restricted more or less through the back door.

… everything seemed so easy, and everyone agreed

The Taylor principle describes how it is the job of monetary policy to optimise the system and it is the heart of what is referred to as the "New Consensus in Macroeconomics" (NCM)[6] – the macroeconomic model that has dominated monetary policy for decades.

This consensus boils down to three basic equations:

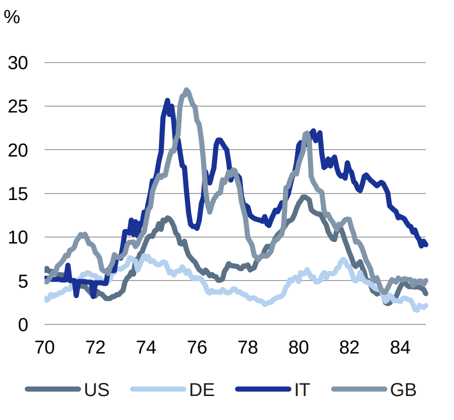
i. Output gap: determined via a macroeconomic demand function that depends primarily on the real rate of interest.

ii. Inflation: determined by a Phillips curve model using as variables the output gap and inflation expectations.

iii. Interest rate: the rate level targeted by monetary policy, or the deviation from the neutral real rate of interest, determined by the Taylor equation by using the values ascertained for the output gap and the inflation rate from the first two equations.

Therefore the system of three equations with three unknown variables can be solved. The worldwide "achievements" of monetary policy based on this principle seemed to confirm the merits of this approach. In the major industrial countries, the pace of inflation had slowed noticeably in the past twenty years. In 2002, the US economists Stock and Watson coined a phrase for this period, calling it the "Great Moderation". Central bankers around the world embraced this term and claimed that they were responsible for a significant part of this success. In 2004, as a member of the Board of Governors of the Federal Reserve, Ben Bernanke declared: "My view is that improvements in monetary policy, though certainly not the only factor, have probably been an important source of the Great Moderation"[7]. Bundesbank President Jens Weidmann made a similar comment at the beginning of this year[8].

Developed countries: inflation rates 1



Source: IMF

In the opinion of the central banks, this provided proof that the right lessons had been drawn from the inflationary periods of the 1970s and 1980s. During the two oil price shocks, many countries influenced by Keynesian ideas had attempted to cushion the loss of real income at home via accommodative monetary policy. As a result, inflation rates increased substantially. They reached 14.6% in the United States (March 1980); they rose at times to over 25% in the UK and Italy (1975 and 1974); and even the Federal Republic of Germany posted an inflation rate of 7.9% at end-1973. These sobering figures provided the final breakthrough for Milton Friedman's monetarist theory. He claimed that monetary expansion is able to stimulate the real economy – at best

5 See also: Inflation risk in monetary policy: Is it too loose for Germany? Focus Germany. April 2, 2013.

6 Does money matter? L.H. Meyer. In: Federal Reserve Bank of St Louis Review. Vol. 93, No. 5, 2001.

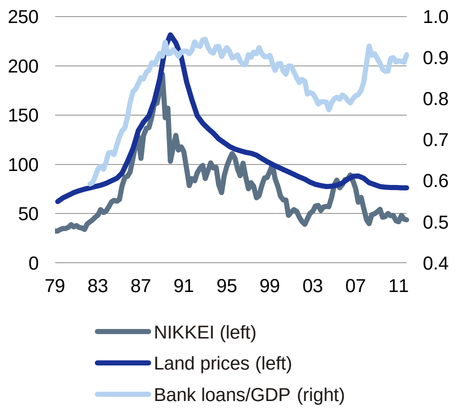
7 The Great Moderation. Ben Bernanke, speech at the meeting of the Eastern Economic Association. Feb. 2004.

8 The depoliticisation of money and central banks' stability orientation undoubtedly made a key contribution to the great moderation. Pressing ahead. Priorities for 2013. Speech given at the Deutsche Börse Annual Reception. January 2013.

– in the short term, with the impact disappearing over the medium to long term while inflation accelerates. This means that an inverse relationship between inflation and unemployment, which policymakers sought to exploit in the 1970s and early 1980s, only exists for a short while at the longest. However, the Phillips curve describing the relationship between inflation and unemployment is vertical in the long term and thus – with regard to growth – monetary policy has no impact (is neutral) in the long term. The related inherent temptation for policymakers to want to stimulate the economy in the short term at the cost of higher inflation in the medium term is identified as a time inconsistency problem and was the main reason for handing over responsibility for monetary policy to independent central banks. In the period between 1995 and before the crisis in 2007 monetary policy appeared "to have reached a new form, even a final resting-place"[9] – it looked like nirvana had been attained.

Japan: Bank loans, Nikkei & land prices 2

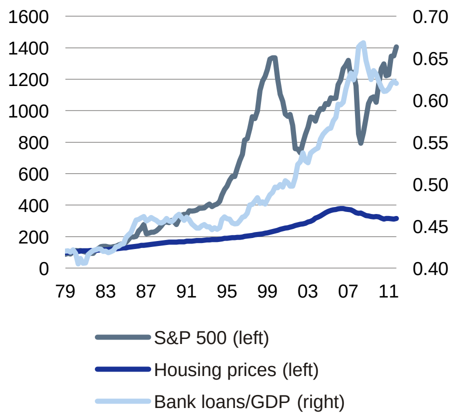
March 2000 = 100



Source: Thomson Reuters

USA: Bank loans, S&P 500 & house prices 3

1980 =100



Quelle: Thomson Reuters

The flaws of the monetary approach

The Taylor principle is based on the neoclassical/monetarist schools of thought, with their view that the economy is inherently stable and tends to rapidly reach a new equilibrium in the wake of a disruption. The role of monetary policy is thus confined to smoothing the fluctuations in the system via variations in the interest rate. However, the Taylor principle also reveals the flaws in a relatively myopic, technocratic monetary policy that is aimed at optimising a simple social welfare function with the variables of price stability and trend growth.

The charm of the Taylor rule is that the task of monetary policy can be depicted in a simple equation with a manageable number of variables. However, not only conceptual problems but also substantial measurement problems exist for all variables. Back in 1974, Friedrich August von Hayek pointed out in his Nobel Prize acceptance speech that the social sciences dealt with "phenomena of unorganized complexity" and he doubted whether their "search for measurable magnitudes has made significant contributions to our theoretical understanding of economic phenomena"[10].

There has not been any lack of "systemic accidents" that could have triggered a more general re-examination of the approach. The Japan crisis in the early 1990s, the Asia crisis at the end of the 1990s and the "irrational exuberance" that led to the "new economy bubble" as diagnosed by the leading central banker of the era, Alan Greenspan, could all have contributed towards a more self-critical attitude. Instead, at the end of the day the central bankers' apparently successful short-term stabilisation efforts probably only contributed to their hubris. In this case, an analysis based on the Austrian School of thought, which focused on credit-induced misallocation of investment and the imbalances thus triggered in the real economy, could probably have been of assistance. One particularly helpful insight is that a perpetuation of imbalances via accommodative monetary policy only increases the scale of the ultimately inevitable adjustment crisis[11].

Patchy definition of gaps

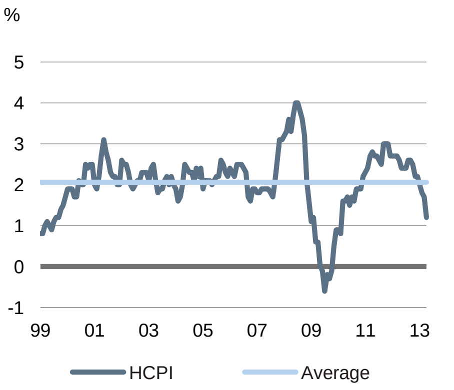
Nonetheless, monetary policy focused on the short-term fluctuations in growth around its potential rate, the output gap. Yet their very own research showed the makers of monetary policy that estimates of output gaps in real time are

[9] David Cobham. loc. cit.
[10] Friedrich August von Hayek. Prize Lecture: The Pretence of Knowledge. Nobelprize.org. May 17, 2013. http://www.nobelprize.org/nobel_prizes/economics/laureates/1974/hayek-lecture.html.
[11] I'm an Austrian in economics. Thomas Mayer. Deutsche Bank Research. Current Issues. September 16, 2011.

extremely unreliable, and later revisions may regularly be of a magnitude similar to the output gap itself[12]. Moreover, potential growth is probably influenced by the development of demand and thus by monetary policy; this retroactive effect can substantially complicate the use of the Taylor rule as the steering function. So, at the end of the 1990s, the incumbent head of the Fed, Alan Greenspan, justified his comparatively loose monetary policy by pointing to a presumed acceleration of productivity growth, the "productivity miracle". He did not want overly tight monetary policy to curb the additional investment opportunities resulting from the acceleration of productivity and thus the expansion of the "new economy". Potential growth is usually estimated by using filter techniques to smooth out cyclically induced fluctuations. However, the trend growth rate can be systematically overestimated if an overly narrow definition of inflation underestimates the pace of price development. Correspondingly, the monetary policy conducted on this basis may be too relaxed as a result. It follows that on a cyclical average the growth rate could exceed the equilibrium trend rate.

Overly narrow definition of price stability

EMU: Inflation and long-term average 4

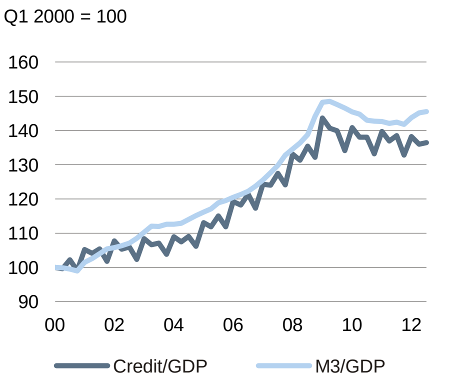


Source: Eurostat

Usually, the inflation rate is measured by looking at the prices of goods and services consumed within a given period. At the same time, prices of assets that can be a reflection of overly loose monetary policy are disregarded. Even after the outbreak of the European debt crisis, which was certainly caused in part by a dramatic real estate bubble, the then president of the ECB, Jean-Claude Trichet, lauded the average inflation rate of less than 2% – 1.97% to be precise[13] – during the first 12 years after the euro's launch as evidence of successful monetary policy. Recent research suggests that the relationship between an economy's output gap and the inflation rate has decreased on account of globalisation, while the global output gap has gained significantly in influence. This not only casts a different light on the ECB's "success in maintaining price stability" and that of other central banks around the world. It also raises the general question of the extent to which monetary policy can still manage inflation via the interest rate and the latter's impact on demand within an economy, as is the underlying assumption of the Taylor rule.

Asset prices – "none of our business"

EMU: Credit & M3 5



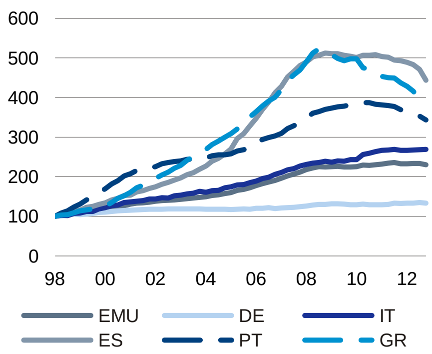
Source: ECB

The way of dealing with asset prices in monetary policy is very reminiscent of the widespread practice in economics of simply removing an overly complex aspect from a model and relegating it to the underlying assumptions. For decades, central bankers have resisted calls for "leaning against the wind", that is, responding to an unusually pronounced increase in asset prices with monetary action in order to avoid any financial crises that could possibly emerge as a result. In what is known as the Jackson Hole consensus, the central bankers agreed that asset bubbles were difficult to spot, interest rate hikes were too crude an instrument to influence asset prices, that such action would contradict the Tinbergen rule (at least one policy tool per target) and that therefore the role of monetary policy should be confined to a "mop-up" strategy after a bubble bursts in order to cushion the impact on the real economy. Moreover, it was agreed that price stability should normally help ensure the stability of the financial markets[14] and help accordingly to avoid the development and bursting of asset bubbles. However, in the run-up to each of the major crises of the past one hundred years, e.g. the Great Depression, Japan, Asian

[12] The Reliability of Output Gap Estimates in Real Time. Athanasios Orphanides, Simon van Norden. August 1999.
[13] Jean-Claude Trichet. Interview in the Weser-Kurier. Own translation. February 13, 2011.
[14] Monetary and financial stability – is there a trade-off? Otmar Issing. Speech at the BIS. March 2003.

Loans to households & non-financial corporations 6

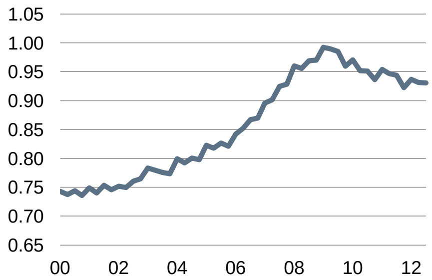
Q1 1998 = 100



Source: ECB

G4: Bank loans 7

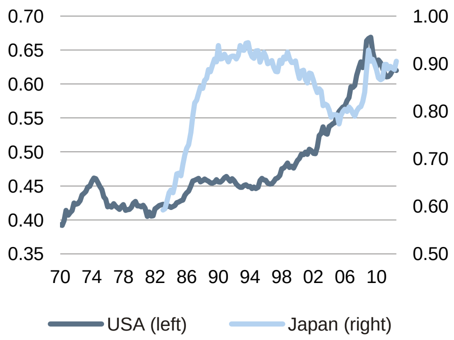
Relative to GDP



G4 = USA, Japan, Euroland & UK

Sources: ECB, Eurostat, Fed, BEA, Bank of Japan

Credit / GDP 8



Sources: Fed, BoJ

crisis, the "new economy" and not least the global financial and economic crises, inflation was very moderate.[15] This was partly the reason for the resultant emergence of a contrarian view, the so-called "new environment" hypothesis, which says that precisely long phases of stable consumer prices may lead to asset bubbles in other areas of the economy and thus to the instability of the financial system.

All in all, the Jackson Hole consensus probably encouraged an exaggerated degree of risk taking in the financial markets, which referred to this policy tack as the "Greenspan put". The banishing of asset prices from the monetary response function ultimately caused the entire financial sector to be reduced to a negligible element of monetary policy analysis. Attention focused on an interest rate, the rate for central bank liquidity determined by the Taylor equation, a rate which is strongly reminiscent of Knut Wicksell's natural rate of interest. It leads in times of full employment to equilibrium between savings and investment[16]. Credit and maturity spreads, leverage and credit growth, factors which reflect the development of asset prices – in a nutshell: the financial system – did not play a role in the world of the Taylor equation and output gaps.

Financial cycles – not on the central banks' radar

More recent analyses, including those of BIS economist Claudio Borio, show though that financial cycles have a substantial influence on economic development that far exceeds growth cycles[17]. Borio identifies financial cycles by looking at the deviation of credit and real estate price developments from their long-term trends; he found that the dynamics of the process are fed by the interaction of the two components. Financial cycles have an average duration of 16 years. Lately, their duration has probably increased to twenty years, no doubt partly in conjunction with the liberalisation and deregulation of the financial markets. The ultimate challenge to conventional monetary policy – and grist to the mill of its critics – has been Borio's claim that with the help of the financial cycle concept it would very well have been possible to measure the build-up of risk of financial crises in real time; furthermore, he asserts that financial boom phases not only precede the bursting of a bubble, but almost inevitably generate subsequent busts.

One reason for this quasi-exclusion of the financial sector from the realm of monetary models, which in retrospect is virtually impossible to comprehend, might lie in the assumptions aspect. Given rational expectations, efficient markets and economic agents that act strictly in line with homo economicus assumptions, erroneous assessments, bubbles and financial crises are nearly out of the question[18]. Supporters of this view hoped, in fact, that financial market deregulation – for example, the abolition of the Glass-Steagall Act in 1999 and the development of sophisticated financial products in the 1980s and 1990s – would further boost the efficiency of the system, since products such as asset-backed securities would ensure more efficient distribution and assessment of risk. During a hearing before Congress on the causes of the financial market crisis former Fed Chairman Alan Greenspan rocked this pillar of monetary policy orthodoxy. He stated: "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief." Looking at the market for credit default swaps and its

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[15] Is price stability enough? William R. White. BIS Working Paper. No 205, 2006.
[16] A critical reconsideration of the foundations of monetary policy in the new consensus macroeconomics framework. Philip Arestis and Malcolm Sawyer. Cambridge Journal of Economics 2008, 32.
[17] The financial cycle and macroeconomics: What have we learnt? Claudio Borio. BIS Working Papers. No 395, December 2012.
[18] Homo economicus – or more like Homer Simpson? Stefan Schneider. Deutsche Bank Research. Current Issues. June 29, 2010.

role in modern risk management, he conceded: “The whole intellectual edifice (...) collapsed in the summer of last year.”[19]

Against this backdrop, the question that arises is to what extent the lessons from past experience have been drawn. Fundamentally, these lessons need to be drawn in two areas: first of all, adequate account of asset price developments has to be taken when setting monetary policy and, secondly, financial imbalances have to be contained to secure financial stability and thus, implicitly, monetary policy has to be relieved of this duty. As far as the first aspect is concerned, monetary policy is faced with a dilemma: on the one hand, as discussed above, it can give rise to risks to monetary and financial stability if central banks ignore asset prices and, on the other, asset prices and their effects on the balance sheets of banks and the private sector are an important transmission channel for monetary policy, especially considering the currently weak responsiveness of credit demand to interest rates and the zero rate barrier. The current situation illustrates this dilemma: one of the main effects of quantitative easing is that risk assets are meant to become more appealing – but at the same time several market segments are showing signs of over-heating, and their corrections could entail renewed problems for financial market stability. According to newspaper reports, the “covenant-lite” share in leveraged loans has jumped to over 50% and thus back to the level of boom year 2007[20].

As to containing asset bubbles, with the establishment of macro-prudential supervisory authorities (e.g. the FSOC in the US and the ESRB in Europe) the political authorities have created watchdogs to identify financial imbalances and take preventive measures to deal with them. This has relieved the central banks of the responsibility for this task more or less at the institutional level. Nevertheless: there are many doubts about how effective the macro-prudential supervisors really can and will become; furthermore, the central banks – also and especially in Europe – play a leading role among the macro-prudential supervisors – and are thus the bearers of responsibility after all (see below).

Independent central banks – are their days numbered?

An analysis of the triggers of the financial crisis shows that the central banks, their interest rate policy and role in regulatory issues played a major part. In retrospect, former ECB Chief Economist Otmar Issing sees the Great Moderation as a short episode and a fundamental illusion. He thinks it is almost inevitable that the effects of the crisis will lead to a considerable reputational loss for the central banks[21].

Controversial role in “financing” of government debt

But it is not only past mistakes that are weighing on the central banks’ image. During the financial crisis, the central banks turned from lender of last resort, who – if necessary – provides the financial system with unlimited liquidity, additionally into saviour of last resort, who – if need be – acts as ultimate purchaser of government bonds and other securities[22]. The reasoning behind this is the idea of monetary and fiscal policy coordination, with the state – supported by the central bank – acting as borrower of last resort in light of anaemic private credit demand, as the central bank on its own would not be

[19] The New York Times. October 23, 2008.
[20] Financial Times. May 28, 2012. “Covenant-lite” refers to loans where the creditor waives – normally common – rights to influence the debtor's business policy if the latter runs into economic problems.
[21] Central Banks – Paradise Lost. Otmar Issing. Mayekawa Lecture, Institute for Monetary and Economic Studies Bank of Japan. Tokyo, May 30, 2012.
[22] Issing, loc.cit.

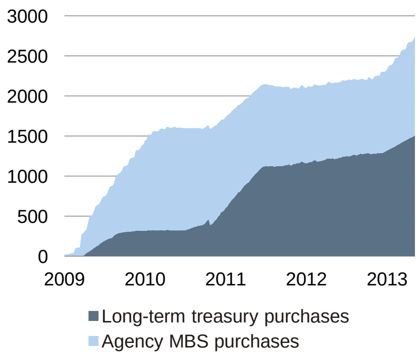
able to ward off the deflation and depression risks resulting from a lack of private credit demand.

In many cases, the central banks are considered – not least by financial market participants – to be the last remaining party able to take action. This notion is further encouraged by official statements such as ECB President Mario Draghi's famous "whatever it takes" or Ben Bernanke's "Deflation: Making sure "it" doesn't happen here"[23]. This takes the pressure off national policymakers and European rescue efforts, while monetary policy is turning itself more and more into a scapegoat of last resort for potentially disappointing economic and labour market developments in the foreseeable future.

Watering-down of the institutional roles of monetary and fiscal policies

US: Quantitative easing 9

Purchases of assets by the Fed, USD bn



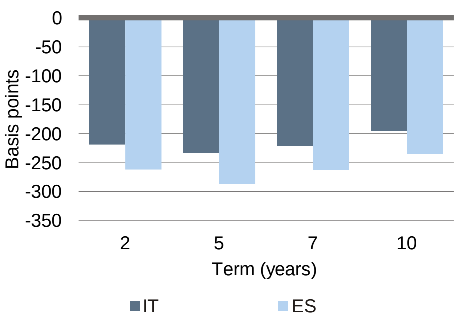
Source: Federal Reserve Bank of Cleveland

Coordination of monetary and fiscal policies no doubt makes sense as long as the independence of the central bank is maintained – especially in times of economic crisis. It becomes a problem, though, if this coordination comes at the cost of the primary objective of monetary policy, or at the very least if the active participants and the public gain even the faintest impression that this is the case. In the US and the UK, the volume of quantitative easing in the form of bond purchases (QE) is pretty much in line with the increase in budget deficits, creating the impression of at least coordinated monetary and fiscal policies[24]. For example, in the past five years – except for the global economic slump in 2009 – the Bank of England has always missed its inflation target, and in some cases by a wide margin. As the successor to outgoing BoE Governor Mervyn King, the government has chosen a candidate who explicitly favours a more relaxed approach to the inflation target. In Japan, it appears that one key criterion for the nomination of the new central bank governor was that he explicitly supported the government's reflationary policy. In Europe, via its SMP programme and, even more so, via its OMT programme, the ECB has also encouraged the impression of the borders eroding between monetary and fiscal policies by holding out the prospect of government bond purchases, formally a typical instrument of open-market policy, to support reform and consolidation policies previously agreed with the country affected. However, while bond purchases in the context of open market policies usually serve to provide additional liquidity and influence risk-free interest rates, critics claim that OMT is aimed at safeguarding the solvency of individual Eurosystem member states[25][26]. In its ruling of September 12, 2012, for example, Germany's constitutional court referred once again to the existing legal situation, stating that secondary market purchases must not represent non-compliance with the ban on primary market purchases and the underlying prohibition of monetary financing of governments by the ECB. Moreover, critics have argued that by purchasing government bonds and tolerating massive increases in Target2 loans the ECB has circumvented the prohibition of joint EU liability without consultation of the national parliaments.[27] Since, to date, OMT has not yet been activated, it is difficult to gauge ex ante – and probably also ex post – whether its concrete application will be a case of safeguarding solvency or, as the ECB emphasises, a measure to deal with a disruption of the monetary transmission mechanism. Furthermore, the ECB points out that the existence of a

[23] Deflation: Making sure "it" doesn't happen here. Ben Bernanke. Remarks before the National Economists Club, November 21, 2002.
[24] David Cobham, loc.cit.
[25] Statement to the German Constitutional Court. Deutsche Bundesbank. December 21, 2012.
[26] A similar interpretation seems the obvious choice in the case of the short-term increase in the ELA limit of the Greek central bank in August 2012, when according to press reports considerable pressure was brought to bear on the ECB by the finance ministers (Kritik an EZB-Hilfen für Athen, Handelsblatt, August 7, 2012).
[27] Funktionswandel der EZB? Baldige Rückkehr zur alten Rolle erforderlich! T. O. Berg, K. Carstensen. In Wirtschaftsdienst 2012/2.

Memorandum of Understanding is a necessary condition for the activation of OMT, but it is not sufficient per se, and that its decision on the continuation of an ongoing programme is independent of the political assessment of the MoU's fulfilment[28].

Yield changes: Since Draghi's "Whatever it takes" 10

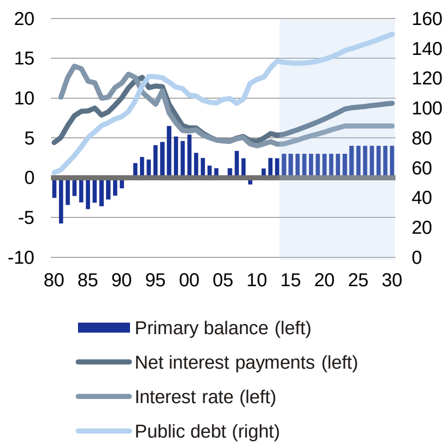


Source: Thomson Reuters

Above and beyond OMT, many observers believe the ECB has problematically neared the political sphere due to its participation in the Troika. The ECB's inclusion in the Troika certainly makes sense against the backdrop of the target of fast, coordinated crisis policies and especially because of the exposed position of the European banking system and the resultant nexus of sovereign debt crisis and systemic stability; however, it also harbours the risk of doing damage to the central bank's economic reputation. This is reflected not only in the uncomfortable questions regarding the ECB's role in the negotiations about a rescue package for Cyprus, in the context of which ECB President Mario Draghi confessed that the ultimately revised result of the negotiations, which had foreseen a "bail-in" also of small bank deposits, "... was not smart, to say the least".[29] Even though the proposal probably came from the Cypriot government, the ECB could have intervened with the obvious factual arguments that ultimately prevailed. The ECB's participation in development paths for both the Greek economy and Greece's government debt, which were probably strongly influenced by politics and in the end proved to be completely unrealistic, is likely to have had the same effect.

Italy: Public finances what-if scenario 11

% GDP, %



Assumptions: Nominal GDP +2.5% p.a., primary budget surplus increases to 4% of GDP, average interest rate rises to 6.5% by 2023

Sources: European Commission, DB Research

All in all, by entering into political cooperation the ECB – like other central banks – has moved in a direction which it is finding hard to change. Naturally, in its orientation it is the job of monetary policy to consider the short-term, negative Keynesian effects of a fiscal consolidation policy or of a supply shock triggered by reform efforts, and thus to keep the adjustment burdens to a minimum. However, the ECB is in a strategically unfavourable position relative to the political authorities. Former ECB Council member Athanasios Orphanides has argued in a presentation[30] that the existence of the ECB as the ultimate saviour has taken the pressure off governments of having to bear the full political cost of preventing a looming collapse. This has led to a situation where the political measures offered – ranging from the establishment of the EFSF to the introduction of a banking union – have induced the ECB to take supportive measures (LTRO, SMP, OMT) which in many cases have resulted in a watering-down of the initial political measure due to waning pressure on politicians to take action.

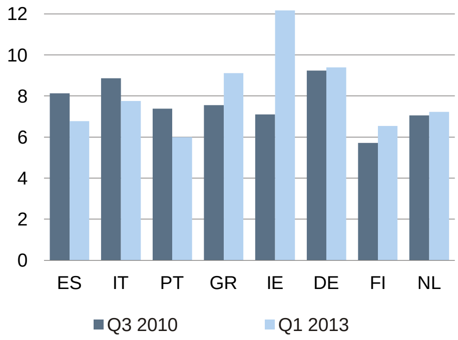
Should OMT actually be activated, moral-hazard problems stemming from the conditionality of the programme are likely to materialise quickly – unless the ECB, as a preventive measure, were to agree to weak reform and consolidation conditions in order to ward off this dilemma. This would continue to fuel criticism from the core countries, especially if purchase volumes were to rise quickly.

On the announcement of OMT and its focus on shorter maturities of up to three years alone, yields in the peripheral countries in this maturity segment plummeted, boosting the incentive to take up relatively short-term debt. Should the average residual maturity of government debt be shortened considerably, an ECB rate hike would quickly raise interest payments by these countries and, with trend growth at a persistently weak level, could set in motion a debt spiral. Political pressure on the central bank to postpone interest rate hikes would correspondingly be high, especially as the ECB would be confronted with a dilemma since it is responsible for the stability of the financial markets. This issue has been raised explicitly by the IMF in its recent World Economic

[28] Opinion of Frank Schorkopf commissioned by the ECB for Germany's constitutional court. January 16, 2013.
[29] Introductory statement to the press conference (with Q&A). ECB. April 4, 2013.
[30] IMFS-HoF Symposium Central Banking: Where are we headed? Segment II: Monetary policy, fiscal policy and the politics of EMU. Frankfurt. February 7, 2013.

Time to maturity of Gov't bonds 12

Average weighted time to maturity of Gov't bonds



Source: Bloomberg

Outlook[31], even though the IMF currently sees no inflationary risks and is an outspoken advocate of ultra-expansionary monetary policy.

However, the Bank of Japan's current policy of seeking to bring the medium-term inflation rate towards 2% by doubling the monetary base within two years stands a disproportionately greater risk of failing. In this context, there could either be a significant overshooting of inflation and inflation expectations, or else the measures could also play out without managing to exert a substantial effect on inflation.

Surely, the central banks can recoup lost confidence if they satisfactorily manage the exit from unorthodox policy measures and the turnaround from zero or low-interest policies. After all, the situation that developed after the Lehman collapse and the momentum of the crisis that followed were uncharted territory and – all criticism aside – one must appreciate that in fact there was a point when everything was at stake for the ECB – i.e. the continued existence of the euro. In such a situation, a central bank acting responsibly can hardly insist on dogmatism and political doctrine, pass the buck to politicians and then sit back and do nothing – this holds all the more since the complex institutional circumstances in Europe severely hampered a rapid, rigorous political response.

In this respect, the refi rate hikes in April and July 2011 probably even helped create confidence in light of the ECB's intention to achieve a return to normal as quickly as possible, even though the rate hikes proved premature in retrospect and the central bank got no good marks for its ability to judge economic necessities. Given the recent establishment of threshold values under which the unemployment rate has to fall before the Fed raises its rates, it appears that the Fed may attach relatively little weight to the potential medium-term risks to price stability resulting from the expansionary monetary policy.

Bigger tool box kindles political appetite

Apart from the debate over the mixing of monetary and fiscal policies in the narrow sense, the ECB currently runs the risk of being blamed for the failure of initiatives – in whatever shape or form – to strengthen lending to small and medium-sized enterprises in the crisis countries, even though the reasons for this probably lie in the cyclically-induced risk aversion of lenders and potential borrowers.

Generally speaking, the creativity displayed in recent years as regards the set of unorthodox monetary policy measures, such as purchases of certain products to support certain market participants (e.g. US Agencies) or market segments (the ECB's Covered Bond purchase programme), will likely make it more difficult for the central banks to ward off political calls for action based on partial functional disorders. Central bank targets and instruments could thus turn into sensitive political issues[32]. The next cyclical downswing, for instance, will probably rekindle the usual debate about a credit crunch, irrespective of its definition. The central banks will then certainly be confronted with proposals to fight this credit crunch. But if a central bank agreed to these proposals, this could tend to further increase the asymmetry in its response function, i.e. responding with greater determination to deflation than to inflation risks.

[31] World Economic Outlook – Hopes, Realities, Risks. IMF. April 2013.
[32] Zentralbankpolitik: Überforderung statt Langeweile? Hermann Remsperger. SAFE White Paper Series No. 3. May 5, 2013.

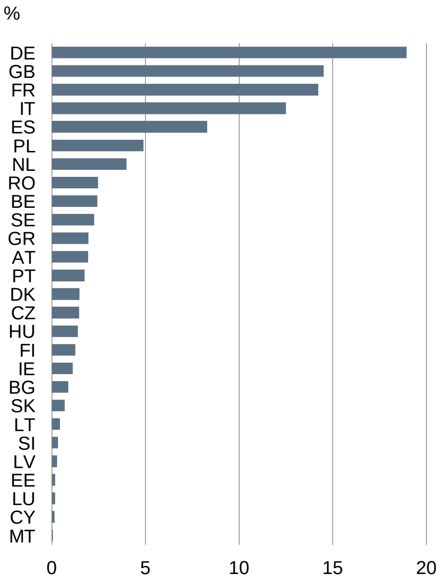
Distribution effects dragging monetary policy into the political debate

Also, the political debate about the distribution effects of the global financial crisis will increasingly call into question the role of the central banks. The combination of tolerating the formation of bubbles (Jackson Hole consensus) and subsequent crisis resolution through interest rate and unorthodox monetary policies has considerable distribution effects, at both the inter-personal and inter-generational levels, which tend to favour current owners of financial wealth. A substantial acceleration of inflation could lead to a reversal of this effect, but also lead to inter-regional distribution effects within the euro area due to heterogeneous economic developments. Finally, potential write-downs on the ECB balance sheet could also trigger major inter-regional distribution effects. As the euro area is not a federal state with a central budget, the taxpayers of one country could – at least to the extent of that country's share in ECB capital – be required to shoulder write-downs occurring in another EMU member country. In light of these effects, the question of the democratic legitimacy of monetary policy is becoming ever more pressing.

Overburdened by new variety of tasks?

In addition, the close involvement of the central banks in macro-prudential supervision as well as their responsibility for micro-prudential supervision (i.e. banking supervision) will likely make the central banks' job an increasingly political one and raise institutional complexity[33]. In the political debate on macro- and micro-prudential supervision, and possibly also the use of the necessary instruments – in which distribution issues will probably play a major part[34] [35] – politicians can also exert an influence over the central banks' monetary policy actions. There is a risk of political capture of the central banks. What's more, in light of their new and wider role, the central banks will be subject to greater accountability and transparency than in their narrowly defined pre-crisis role. Central banks will be forced to enter into a more intensive and critical public debate on a variety of ideas and proposals[36]. After all, it would be naive to believe that with the new tool box, which is still in its infancy, bubbles and financial crises would be a thing of the past. Whenever something goes wrong in the financial system, the central bank will increasingly be called upon to take responsibility due to its considerably widened role. As a consequence, it cannot be ruled out that monetary policy may also suffer collateral reputational damage.

ECB: Capital subscription 13



Source: ECB

New debate over the role of monetary policy in EMU

All in all, the global financial crisis – both its triggers and the way it is being fought – seems to have done more than temporary damage to the reputation of central banks. The dogma of an independent monetary policy has been shaken, particularly because of the close link with fiscal policy. The consequences of the crisis – especially future burden-sharing within the euro area, generally weaker trend growth and the increasing burden of demographics – will probably lead to fiercer distribution conflicts. In light of the strong institutional involvement of monetary policy and the fact that during the crisis it showed flexibility in interpreting its tasks – which in the case of the ECB has led to a broad discussion of the compatibility of its mandate – may induce politicians to pass on part of this burden to the central banks. In Japan, the willingness to implement the govern-

[33] Speyer, Bernhard. Macro-prudential financial supervision and the ESRB: Underestimated potential. Deutsche Bank Research. Research Briefing. May 3, 2012.
[34] Remsperger, loc.cit.
[35] Speyer, Bernhard. EU Banking Union. Do it right, not hastily! Deutsche Bank Research. EU Monitor. July 23, 2012.
[36] David Cobham, loc.cit.

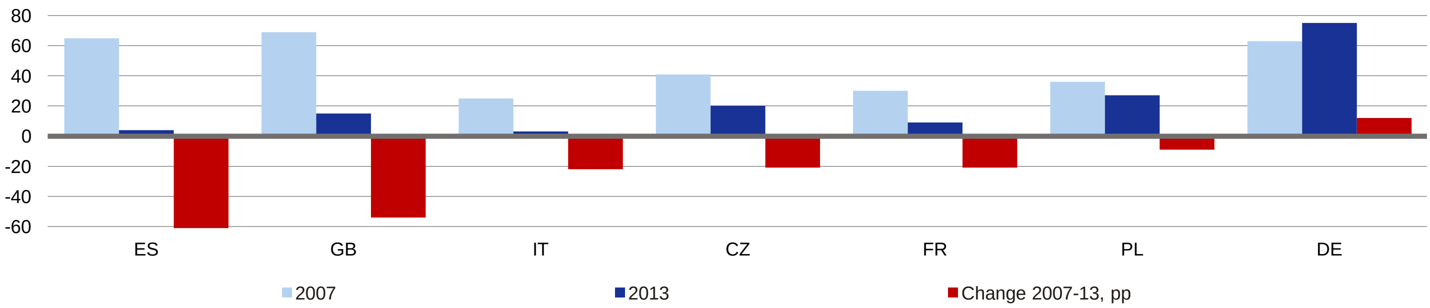
ment's monetary policy guidelines was a "recruitment condition" for the new – formally still independent – central bank governor. We are still a far cry from such practices in Europe. However, should the general public – especially in Germany where the Bundesbank tradition is still firmly rooted – gain the impression that increasing, gradual dependence on political guidance is compromising the price stability mandate, the currently still broad support for the European Monetary Union project could decrease in the medium term.

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

Chart of the month

Germany: Island of the blessed

% share of respondents who think that the economic conditions are good



Source: Pew Research Center

Germany: Island of the blessed

Best way to solve our country's economic problems …

	Reduce govt. spending to reduce public debt %	Spend more to stimulate economy %
France	81	18
Germany	67	26
Spain	67	28
Italy	59	29
Czech Republic	58	26
Great Britain	52	37
Greece	37	56
Poland	36	42
Median	59	29

Source: PEW Research Center

Support for Euro

	Return to own currency %	Keep Euro %
Greece	25	69
Spain	29	67
Germany	32	66
Italy	27	64
France	37	63

Source: PEW Research Center

It's true, the “Island of the blessed” moniker is trite, and we have already used it on a number of occasions. It is, however, a particularly accurate characterisation of the current mood of the general public in Germany. According to the latest study published by the Pew Research Center, the share of respondents who consider the economic situation to be good has risen in Germany from 63% in 2007 to 75%, while it has nosedived in all the other EU countries surveyed. Just 3% of respondents in Italy currently describe the economic situation as good (2007: 25%), while in Spain the figure has slumped from 65% in 2007 to just 4% now, and in France just 9% (2007: 30%) of respondents assess the economic situation as being good. Germany’s outstanding situation can probably be explained by the stable labour market and wage development in Germany despite the weak growth, whereas the dramatic rise in unemployment in some of the other European states probably led to the drastic collapse in ratings. The unemployment rate in Spain, for instance, has risen from over 8% in 2007 to nearly 27% at last count.

The study delivered even more interesting findings. The level of support for the euro ranged between 63% and 69%, with the highest reading – astonishingly – being found in Greece. Just 25% of respondents in Greece advocated a reintroduction of their national currency, while even in the core EMU countries Germany and France the figures were 32% and 37% respectively. Compared with the findings of last year's study the level of support for the euro has fallen slightly in Greece and France by 3 percentage points and 6 percentage points respectively, while it has risen in Spain (by 7 points) and increased particularly strongly in Italy (by 12 points). In Germany the share has remained unchanged since 2010 at 66%. The euro crisis, however, has led to Germany receiving less complimentary assessments from its neighbours. For instance, Germany is the country most frequently named as the European nation that has displayed the least compassion concerning the problems and that is the most arrogant. At the same time, however, Germany is rated by nearly all other countries as the most trustworthy – only the Greeks regarded themselves to be the most trustworthy nation.

When asked whether the country’s economic problems could best be solved by cutting public spending or via additional stimulus measures the majority of respondents chose public spending cuts. In France the figure was as high as 81%, with just 18% advocating increased spending as a better instrument. In both Germany and Spain the approval for spending cuts was 67%, and in Italy it was 59%. Only in Greece was there a majority in favour of spending increases with 56% of respondents considering them to be the solution to Greece's problems. Given that the recession has already lasted five years and real incomes down by more than 20% and an unemployment rate that has more than tripled to around 27% at last count this seems understandable.

Against this background an average of nearly 80% of respondents cited the lack of employment opportunities as the biggest problem in the country, followed by public debt (over 70%), rising prices (67%) and growing inequality (60%). As with the assessment of the economic situation, Germany differs considerably from its European neighbours in this respect. Whereas for 51% of respondents addressing inequality is the number one priority, just 28% of respondents considered employment to be a major problem in Germany. This is another indication that the “Island of the blessed” tag does apply.

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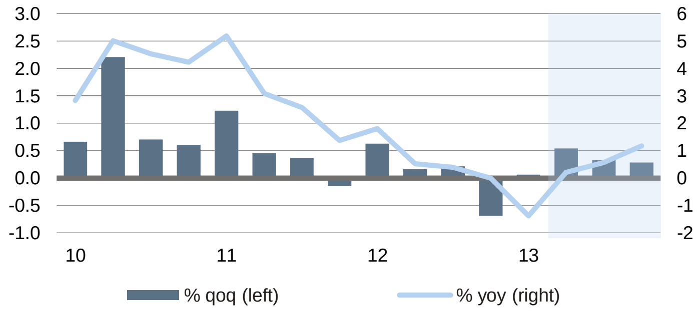
Who is trustworthy, arrogant and compassionate

	EU nation most likely to be named …					
Views in:	most trustworthy	least trustworthy	most arrogant	least arrogant	most compassionate	least compassionate
Great Britain	Germany	France	France	Great Britain	Great Britain	Germany
France	Germany	Greece	France	France	France	Great Britain
Germany	Germany	Greece/Italy	France	Germany	Germany	Great Britain
Italy	Germany	Italy	Germany	Spain	Italy	Germany
Spain	Germany	Italy	Germany	Spain	Spain	Germany
Greece	Greece	Germany	Germany	Greece	Greece	Germany
Poland	Germany	Germany	Germany	Poland	Poland	Germany
Czech Rep.	Germany	Greece	Germany	Slovakia	Czech Rep.	Germany

Source: PEW Research Center

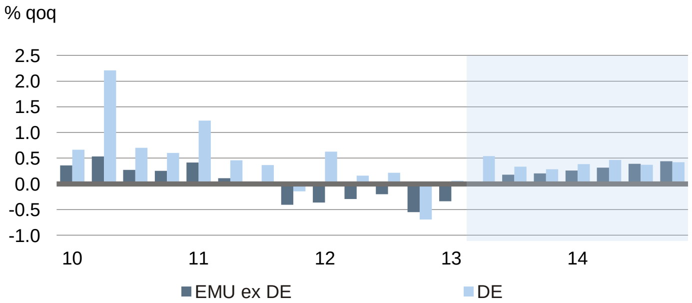
Chartbook: Business cycle (1)

Real GDP growth



Sources: Federal Statistical Office, DB Research

GDP growth: DE vs EMU



Source: Eurostat

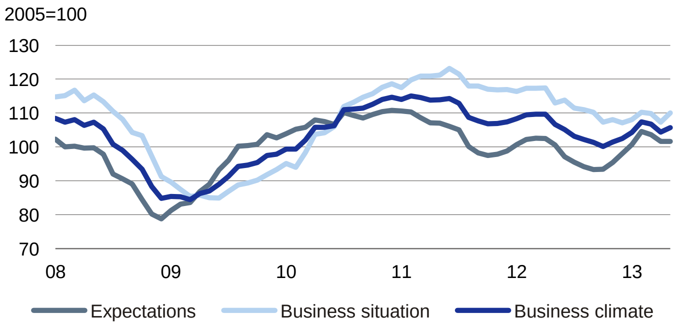
— At +0.7% GDP growth was much lower in 2012 compared to 2011 (+3.0%). Q4 2012 (-0.7% qoq) marked the trough and GDP increased slightly in Q1 2013 (+0.1% qoq). *We expect an acceleration of GDP growth in the course of the year, but due to the statistical underhang our annual GDP growth forecast for 2013 is now only 0.1% (prev. +0.3%).*

— GDP will probably increase relative strongly by 0.5% qoq in Q2 thanks to a weather-related rebound of construction investments and further robust private consumption. Economic growth in 2013 is likely to be supported by consumption. Net exports and investment in machinery & equipment weigh on growth.

— Despite weakening GDP growth during 2012 the German economy fared fairly well compared to other EMU countries which experienced stagnation or even recession.

— Considering the remaining adjustment needs in several EMU countries the EMU economy should remain in recession in H1 2013 and set out on a very low growth trajectory thereafter. Despite the recovery in H2 EMU GDP should decline by 0.6% in 2013 – the same rate as last year – while marked downside risks persist.

Ifo index - total economy



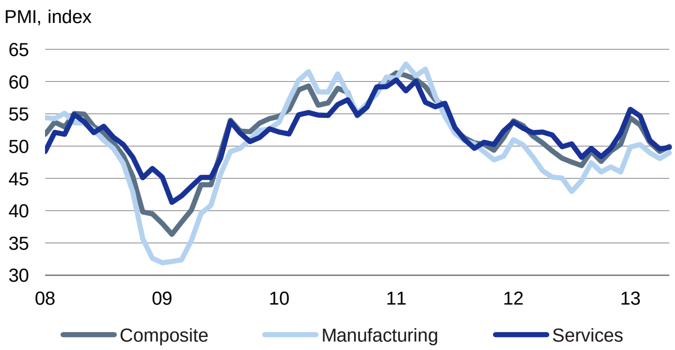
Source: ifo

— After falling for two consecutive times the ifo index increased in May due to a better assessment of the current situation. The index level remained above its long term average. At its current level it points to a GDP growth rate of about ½% qoq in Q2.

— Recently, ifo expectations remained constant due to mixed economic data and political uncertainty esp. within EMU.

— The sentiment increased in all surveyed business sectors except construction in May. However, the export expectations of the manufacturing sector fell in May.

Purchasing Manager Index



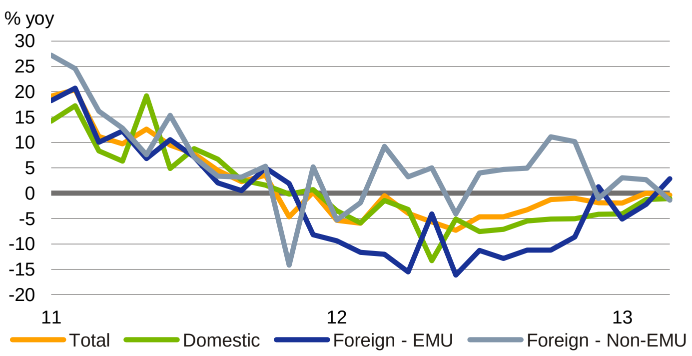
Source: Markit

— The Purchasing Manager Indices (PMI) increased in May – after falling for three times in a row – and was slightly below the expansion level. The manufacturing and the services index were both up. The level of the PMI manufacturing (49.4) was below that of the PMI services (49.8).

— For Germany the PMIs point to a loss of growth momentum, which is a much more pessimistic picture than conveyed by the ifo index. Our preferred indicator is the ifo index since it seems much more in line with hard economic data (e.g. GDP and industrial production).

Chartbook: Business cycle (2)

New manufacturing orders

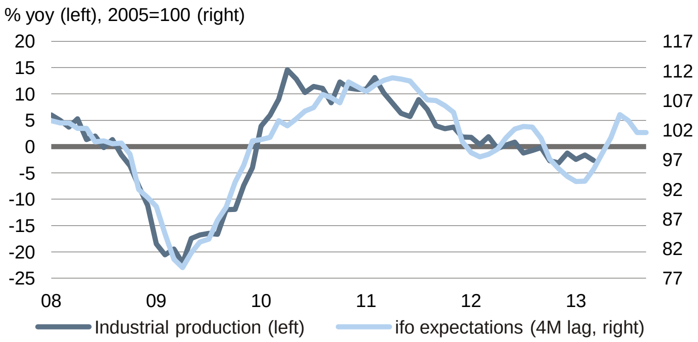


Source: Federal Statistical Office

— Growing by 2.2% mom each month in February and March new orders made up for the weakness in January (-1.6%). In particular core orders (excluding e.g. airplanes and ships) drove the increase of orders in March (+2.7% mom). In March orders are still 0.4% below previous year's level.

— Business surveys (ifo, PMI) point to moderate increases of foreign demand. According to the PMI this trend should remain more muted.

Industrial production and ifo expectations



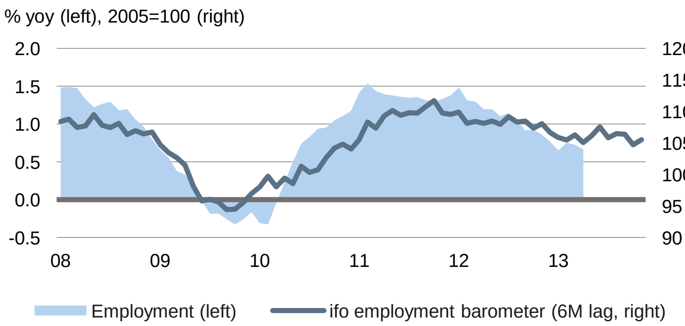
Sources: ifo, Federal Statistical Office

— Industrial production rose by 1.2% mom in March. However, due to the fall in January output in Q1 remained 0.2% below its Q4 level.

— On back of a marked increase in investment goods production (+2.1%) manufacturing output rose by 1.4%. Construction (-3.1%) and energy production (+4.0%) were strongly influenced by weather effects.

— Despite the monthly increase output was still 2.6% below its previous year's level in March. According to the ifo production should accelerate in the next months.

Employment and ifo employment baromter



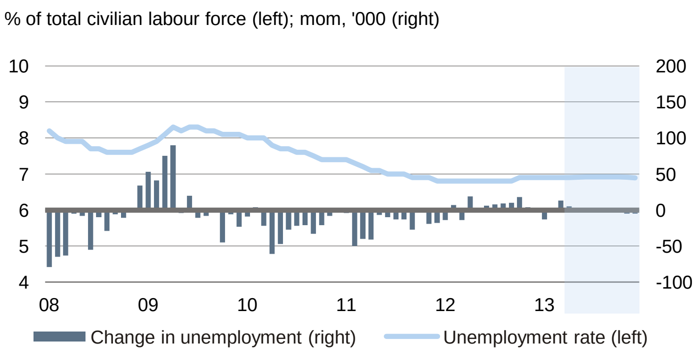
Sources: ifo, Federal Employment Agency

— The number of employed persons is still 0.7% higher than a year ago in April and stands with 41.8 m on a historic high. The level of employees subject to social security payments is up 1.3% yoy.

— However, since the labour market is lagging economic activity, the weak economic development in the winter half (GDP growth Q4 -0.7% qoq; Q1 +0.1% qoq) weighs on the labour market.

— Employment growth weakens year-on-year. While employment grew by 1.2% yoy in April 2012, there was only an increase of 0.7% in April 2013.

Unemployment



Sources: Federal Employment Agency, DB Research

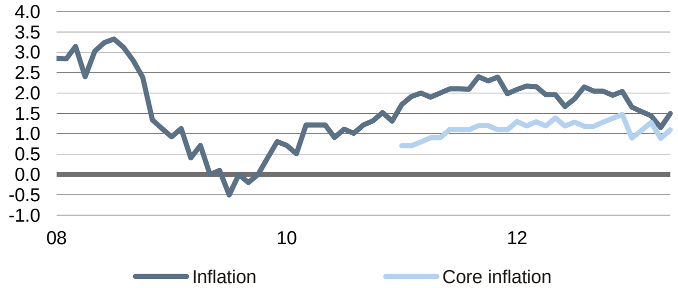
— The number of unemployed persons increased 21k in May which is above market expectations (Reuters consensus: +5k). The increase of on average 10k mom ytd is above the rise of unemployment seen in H2 2012 (on average by 8k per month). The unemployment stayed unchanged at 6.9% in May.

— Early indicators were weak in May, but remained on a relatively high level. We expect that the labour market will start to improve in H2 2013. The unemployment rate should increase slightly to 6.9% in 2013 after 6.8% in 2012 due to the temporary weakness in the winter half year.

Chartbook: Business cycle (3)

Inflation rate and core inflation rate

% yoy (core inflation only available since 2011 due to alteration in statistical collection)

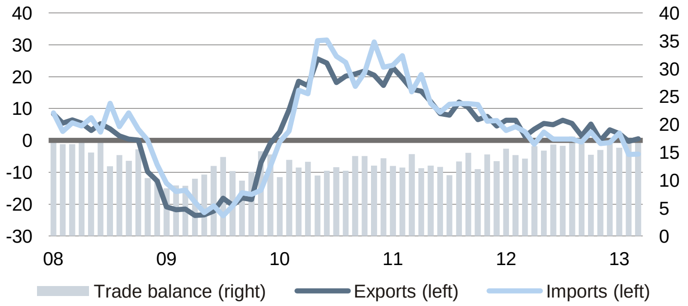


Sources: Federal Statistical Office

- After falling strongly for four times in a row from 2.0% yoy end-2012 to 1.2% yoy in April, consumer prices were up 1.5% yoy in May. This increase was mainly driven by an acceleration of energy and food prices. Excluding these components core inflation increased to 1.1% yoy (prev. 0.9% yoy). This was probably driven by a counter movement of package holidays that fell markedly due to early Easter in April.
- Given the moderate growth and the stabilisation of oil prices, consumer price inflation will probably be muted over the coming month. We expect an average inflation rate of 1.4% yoy in 2013.

Merchandise trade

% yoy (left), EUR bn (right)

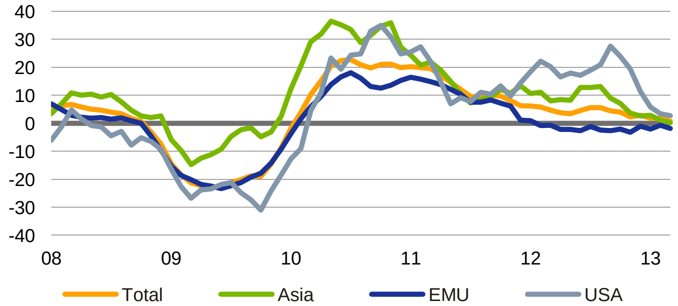


Source: Deutsche Bundesbank

- In March the trade balance was down slightly to EUR 17.6 bn after EUR 17.7 bn before. In Q1 the nominal trade balance increased EUR 4.3 bn to EUR 51.2 bn.
- This larger trade surplus was a result of expanding exports (+0.4% qoq, prev. -2.0%) and declining imports (-1.4% qoq, prev. -0.8%).
- The weakness in imports is likely to be in part due to lower commodity prices and a drawdown of inventory levels. That is suggested by details from the PMI survey.

German merchandise exports by destination

Merchandise exports, % yoy, 3M moving average

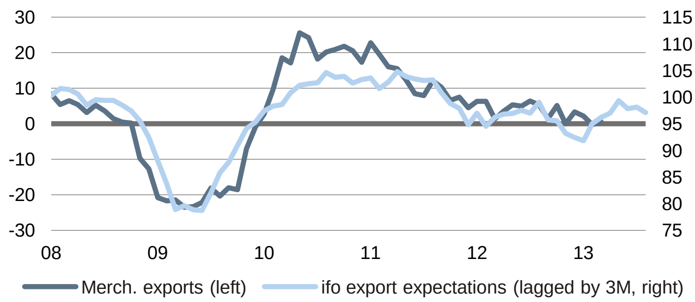


Source: Deutsche Bundesbank

- Since the onset of the euro crisis EMU's share in German exports has dropped by almost 10 percentage points to around 37% (Asia 16% and the US 8%).
- In the wake of the euro crisis and the recession in several EMU countries exports to EMU have fallen below their pre-year level, which was a drag on German trade balance surplus with these countries.
- So far, exports to Asia and the US – automobiles in particular – have managed to compensate for the declines in exports to EMU. However, especially US exports have slowed down strongly lately.

Exports & ifo export expectations

% yoy (left), index (right)

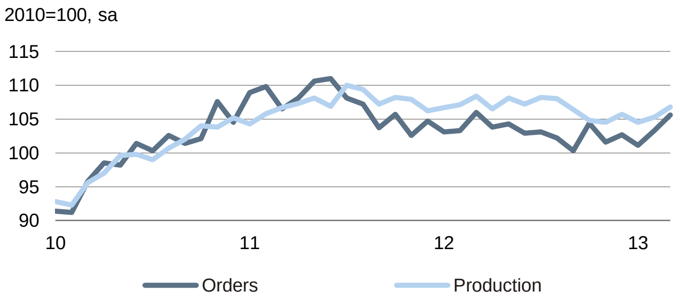


Sources: Deutsche Bundesbank, ifo

- Ifo export expectations had recovered from their lows at the end of 2012 and in the first two months of 2013. Since then the index hovered around and fell in May. The level remained slightly above its long-term average.
- Imports should remain comparably stable, by comparison, due to the stabilisation of commodity prices, the end of destocking, the high level of employment and increases in real income.
- The growth contribution from net exports was slightly above zero in Q1 (+0.1pp; prev. -0.8pp).

Chartbook: Sectors

Manufacturing: Output and order intake



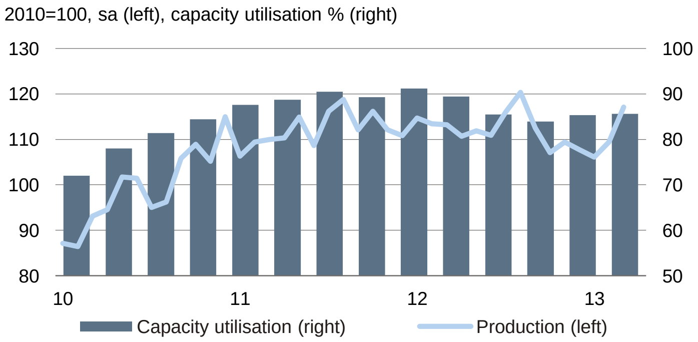
Source: Federal Statistical Office

— Industrial production in Germany declined by 1% in 2012. Output was well below the average of 2012 especially in Q4 2012 which led to a statistical underhang. Order intake in 2012 was 4% below the level of 2011.

— In Q1 2013, industrial production as well as new orders slightly exceeded the level of Q4 2012.

— We believe that industrial output is likely to stagnate in 2013. Risks to manufacturing activity stem from a significant economic downturn in major export markets.

Car industry: Output and capacity utilisation



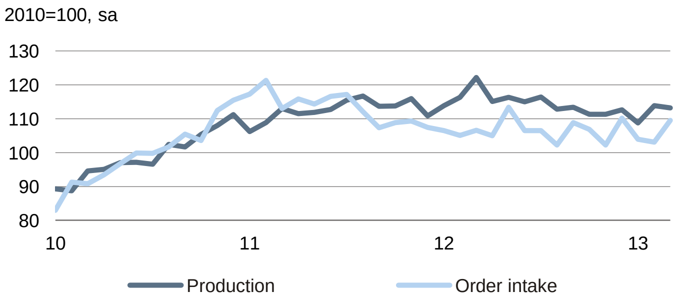
Sources: Federal Statistical Office, ifo

— In Q4 2012, production level in the automotive industry was well below the average of 2012. Output declined marginally last year. However, production increased again at the latest reading.

— Business expectations declined significantly in March and April after having improved for three months in a row; they turned up again in May. Capacity utilisation in the automotive industry has stabilised in Q1 2013.

— Also on account of the statistical underhang we expect output in the automotive industry to fall by 2% in real terms in 2013.

Mechanical engineering: Order intake and output



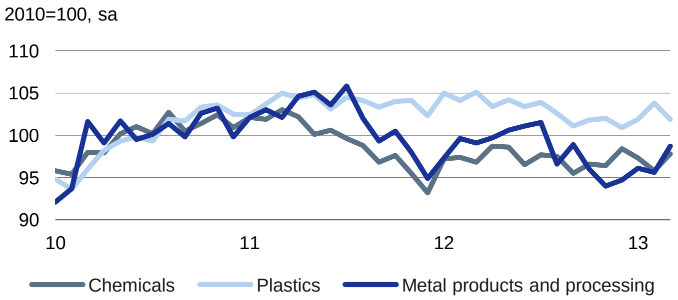
Source: Federal Statistical Office

— With the decrease of new orders in 2012, production momentum in mechanical engineering has slowed. Still, full-year output rose by 1.3%.

— Order intakes in the mechanical engineering industry have sent mixed signals over the last few months. A gradual stabilisation of the euro area and accelerating growth in Asia could support foreign demand in 2013.

— However, for 2013 as a whole we expect mechanical engineering output to decline by roughly 1%, with output trending upwards in the course of the year as the sector will start 2013 with an underhang.

Production: Early cycle sectors



Source: Federal Statistical Office

— The early-cycle sectors currently show no strong signs of a major growth rebound in 2013.

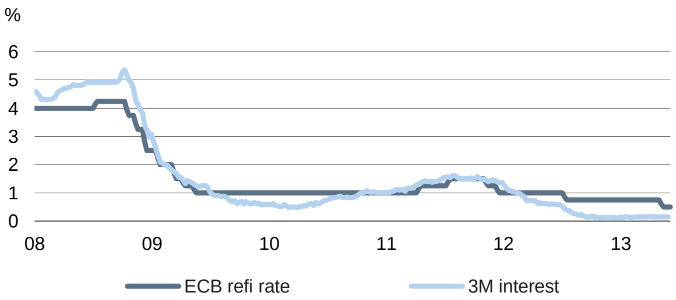
— Production in the chemical industry is expected to increase by 1.5% in 2013 (2012: -2.6%). Output rose again recently after a decline in the first two months of 2013.

— In Q1 2013, plastics production marginally surpassed the level of Q4 2012. Business expectations decreased of late but remain in the positive range.

— Output in metal production could post a marginal increase in 2013 (2012: -3.8%).

Chartbook: Financial markets (1)

EMU: Refi rate & 3M Interest



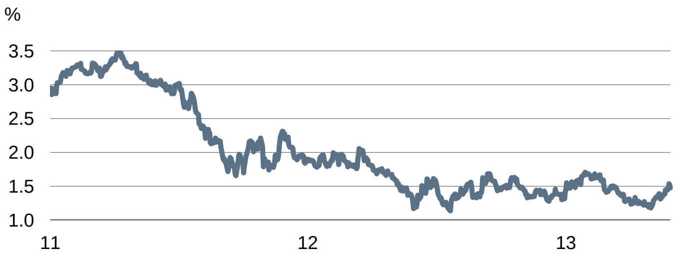
Sources: ECB, Global Insight

— The ECB cut its refi rate by 25 bp to 0.50% on May, 2 due to weak economic data, a declining inflation rate and weak credit demand. The ECB left the door open to cut its refi rate further, if economic data continues to disappoint. *We expect the ECB to cut its refi rate by another 25 bp to 0.25% in July or August.*

— The ECB will be ready to start the OMT under strict conditionality and is examining further measures like the revitalisation of the ABS-market for SME-credits in cooperation with the European Investment Bank.

— The costs of secured interbank refinancing are at a record low of around 0.15% p.a. (-44 bp yoy).

German government bonds: 10Y yields



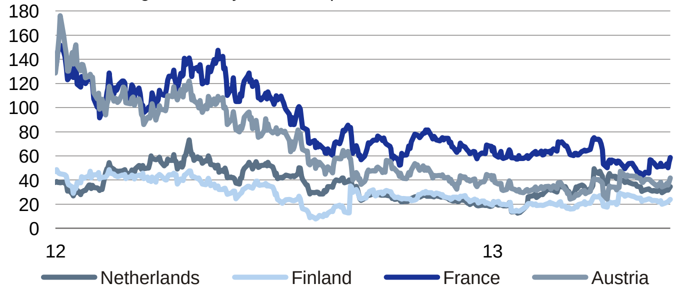
Source: Global Insight

— Given hints from Fed president Bernanke that the Fed could adjust QE3 volumes in the coming months has together with better economic data pushed 10Y Treasuries to 2.2%. With more lacklustre European data and expectations of further ECB easing bund yields have increased to 1.50%, widening the spread from 47 bp at the beginning of May to 65 bp recently.

— Despite real interest rates close to zero many investors favour the "safe haven" of Germany – one of the few countries with an AAA-rating in Europe.

EMU: Bond yield spreads

Versus German govt. bond yield, basis points



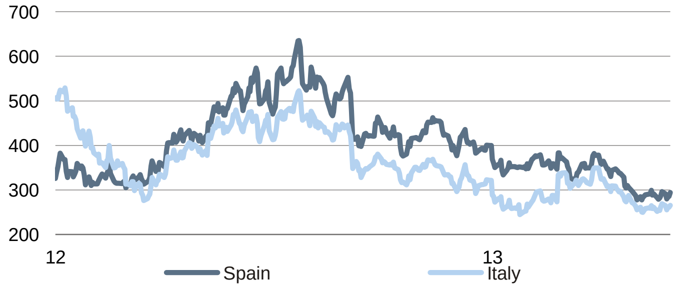
Source: Global Insight

— Intra-EMU bond yield spreads have declined markedly since the announcement by ECB president Draghi that the ECB is ready to do whatever it takes to preserve the euro (26 July 2012) and the clear political commitment – especially by the German government – to hold the Eurozone together.

— In addition, Draghi highlighted the stabilisation of bank deposits in peripheral regions, private capital inflows from abroad, and the reduction of Target2 imbalances as further signs for defragmentation.

EMU: Bond yield spreads

Versus German govt. bond yield, basis points



Source: Global Insight

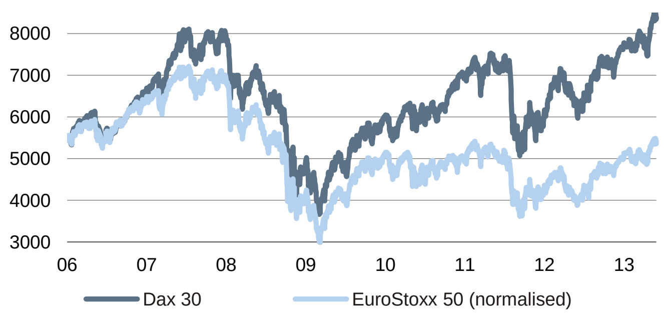
— The yield spreads of Italian and Spanish government bonds were the most sensitive to the prospect of ECB interventions (OMT).

— They fell by about 345 bp and around 260 bp for Spain and Italy, respectively.

— At the short end (3Y) – the focus of the OMT – yield spreads fell by about 65% in Spain and in Italy.

Chartbook: Financial markets (2)

Equity indices

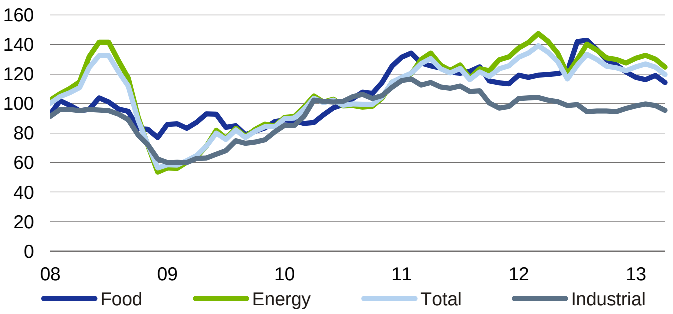


Sources: Global Insight, DB Research

- Currently, the DAX stands at around 8,250 points. The DAX is holding up well lately, not least because of a lack of investment alternatives in the German bond market due to partly negative real interest rates. The difference between dividend and bond yields is currently at a high level.
- The DAX will probably underperform relative to Europe, because there is a chance that the 25-month long downgrade cycle for European earnings 2013 can come to an end in the coming months and weaker Chinese economic data would hit Germany relatively stronger.
- Our equity strategists have a 2013 year-end target of 8000 for the DAX and 315 for the Stoxx600.
- Raw material prices – in particular industrial and energy raw material prices – will probably increase modestly due to a stronger growth in China – the largest importer of raw materials – and a sluggish economic recovery in the industrial countries.
- Food prices increased markedly in Q3 2012 due to droughts (in the US and Eastern Europe for example) and fell markedly again, recently. In April prices are 20% below the last year's peak.

Raw material prices

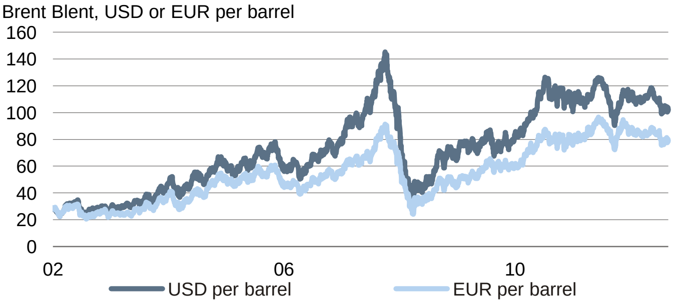
HWWI index, 2010=100, based on EUR



Source: HWWI

Oil price

Brent Blent, USD or EUR per barrel

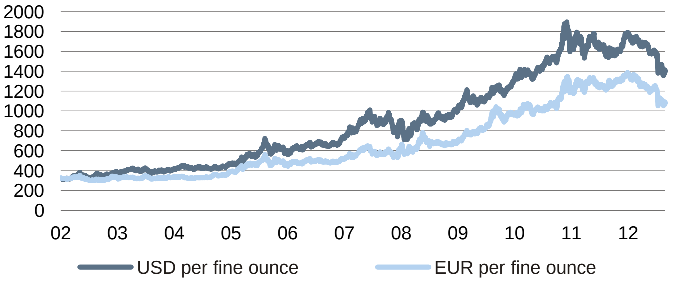


Sources: Global Insight, Reuters, DB Research

- Following a weak winter half year, oil demand should increase in H2 2013 thanks to the recovery of the global economy. Additionally, supply-side factors (e.g. geopolitical risks, Iran) provide some upside risks.
- Currently, the oil price amounts to about USD 100 per barrel Brent. Our commodities analysts expect an oil price of USD 115 per barrel Brent at the end of 2013.

Gold price

USD or EUR per fine ounce



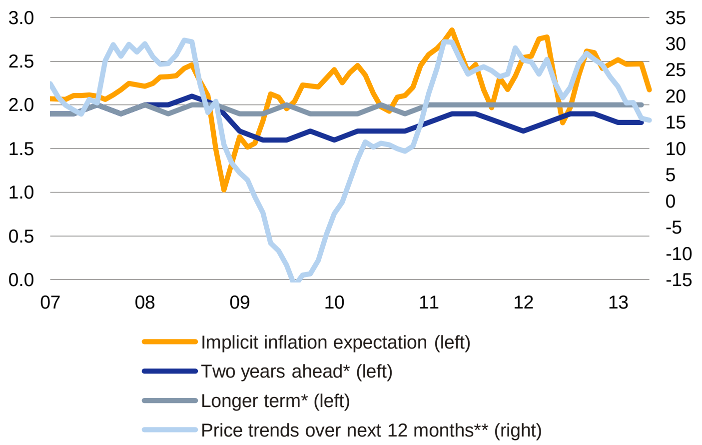
Sources: Global Insight, Reuters, DB Research

- Currently, the gold price stands at around USD 1,400 per fine ounce or more than 20% below the peak value of 2012 (Oct, 4, 2012).
- *Our commodities analysts cut their gold price forecast from USD 1,700 per fine ounce at the end of the year to USD 1,525 per fine ounce. Thus, the gold price is expected to decline yoy (eop) by the fastest pace since 1997.*
- The subdued development is being triggered by increasing signs that a long term uptrend in the USD is underway and dampened inflation rates.

Chartbook: Financial markets (3)

Inflation expectations Eurozone

% yoy (left), balance of pos. u. neg. responses (right)

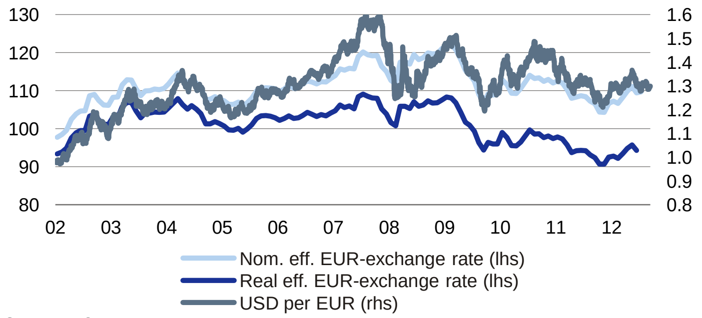


* ECB Survey of Professional Forecasters, ** EC Consumer Survey

Sources: ECB, European Commission, Bloomberg

Exchange rate development for the EUR

1999Q1=100 (left), USD per EUR (right)



Sources: ECB, Reuters

— Contrary to lingering inflation concerns in the general public the private forecasters of the ECB survey expect no increase of the EMU inflation rate. Recently, the expectations for the inflation rate in 2 years and in 5 years remained stable at 1.8% and 2.0%, respectively.

— The implied inflation rate for the next 10 years – calculated as the difference between the yield of 10Y German government bonds and the yield of inflation-protected bonds – hovers between 2 and 2 ½% since the beginning of 2011.

— However, the “implicit inflation expectation” may be biased. On the one hand the current real interest rates close to zero earned on an inflation protected bond is hard to reconcile with economic considerations. On the other hand nominal bond yields are depressed by massive purchases of several major central banks and still persistent flight to quality.

— Since the lowest level of 2012 the EUR appreciated against the USD by 13% to EUR/USD 1.37 – recent peak – at the beginning of February. This comes as a result of a markedly lower tail risk of an EMU break-up which reduced the capital flight from EMU, improvement of the EMU current account balance, more expansive monetary policy of the Fed relative to the ECB and the uncertainty in the USA about the solution to reduce the fiscal deficits.

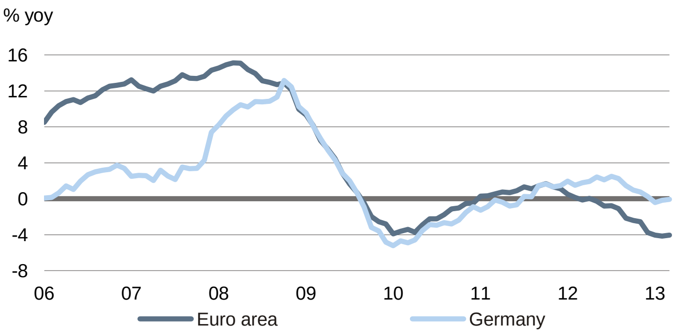
— Due to the political limbo in Italy, difficult negotiations of the Cyprus rescue package and relatively weak EMU economic data the EUR depreciated since the peak in February and hovers around EUR/USD 1.30 since that time. A widening US-EMU growth gap (Q1 US: +2.5% qoq; EMU -0.8% qoq annualised rate) should tend to strengthen the USD.

— Our FX strategists expect a EUR/USD exchange rate of 1.26 in 3 months.

— The USD should strengthen in H2 2013 due to the higher growth rate of the US economy of around 3%. According to our FX strategists the USD will probably appreciate to EUR/USD 1.23 in 6 month. They see the current strength of the USD as the beginning of a multiyear uptrend.

Chartbook: Financial markets (4)

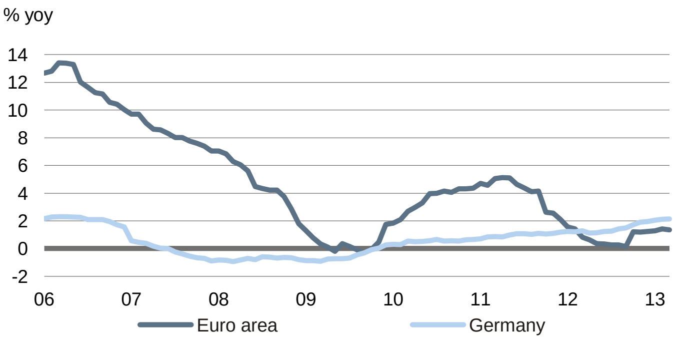
Loans to companies



Sources: ECB, DB Research

- Restrained growth in lending to German corporates in the first quarter. March -0.1% (yoy).
- While Germany's growth remains clearly above the euro area average, the slowdown in investment activity takes its toll on lending volumes. In addition, borrowings are partly substituted by corporate bond issuance.
- Contraction of corporate lending in the euro area continues unabatedly (-4% yoy in March) – mainly reflecting the bleak macroeconomic situation and ongoing deleveraging process in countries strongly affected by the crisis.

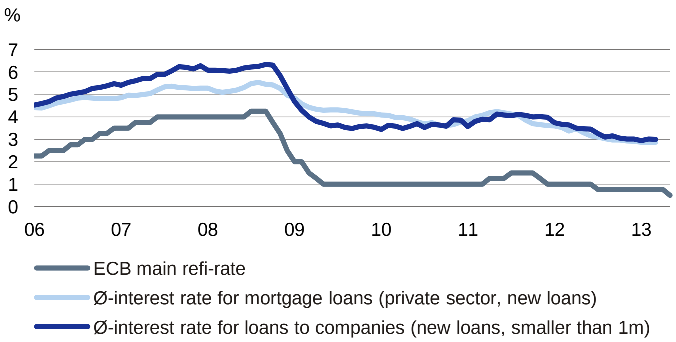
Mortgage volumes



Sources: ECB, DB Research

- Increase in mortgage lending growth in Germany has continued during Q1: mortgage growth at 2.1% yoy in March almost comparable to pre-crisis period.
- Low interest rate levels and a buoyant housing market in some parts of Germany have so far had a limited effect on credit demand in Germany as real estate purchases are in part financed through a reallocation of existing capital.
- German mortgage growth is above the euro area average (1.3% yoy in March).

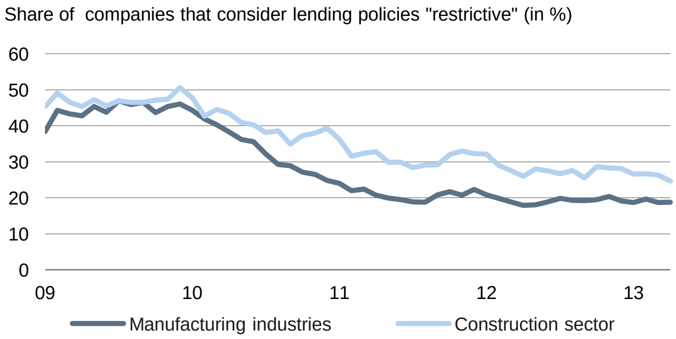
Interest rates



Sources: ECB, Bundesbank

- The ECB lowered its main refi-rate to 0.5% in May.
- Interest rates for mortgages and loans to corporates remained at historic low: 2.9% for mortgage loans in March and 3% for loans to companies.
- The generally low interest rate environment has allowed banks to refinance themselves at relatively low cost, which they partly pass on to clients.

Lending standards



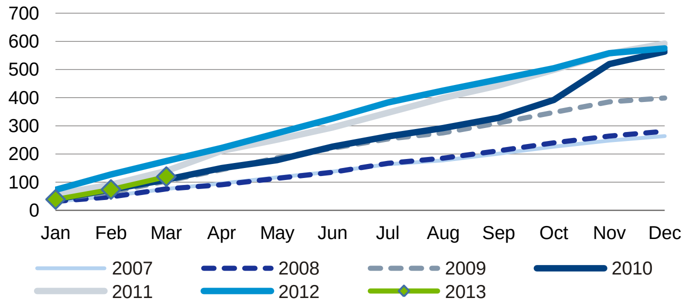
Source: ifo

- Corporates on average saw no problem with credit supply.
- In April, almost no change in the share of corporates from manufacturing industries that consider lending policies restrictive (+0.1 ppt compared to previous month). More pronounced decrease for corporates from construction industries (-1.7 ppt).

Chartbook: Financial markets (5)

Gross issuance of public debt securities

Cumulative issuance volume, EUR bn

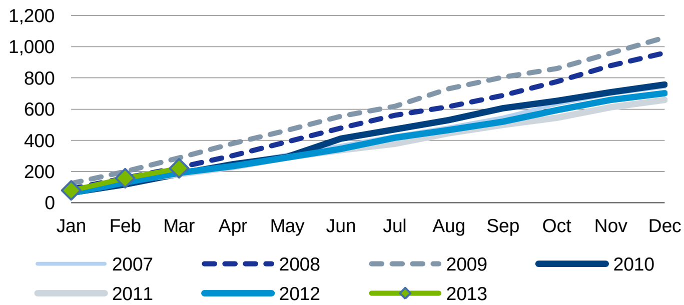


Sources: Bundesbank, DB Research

- Rather weak issuance activity by German public sector compared to the previous two years. Germany's Länder and the federal government issued around EUR 46 bn in March 2013.
- The figures lagged last two year's pace during the first quarter as well, falling to EUR 119 bn in the first three months of 2013.
- German public sector still enjoys the safe heaven effect by offering historically low yields.

Gross bank debt issuance

Cumulative issuance volume, EUR bn

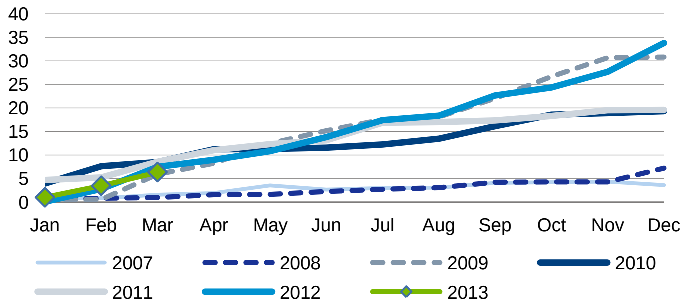


Sources: Bundesbank, DB Research

- Banks continue to issue debt securities somewhat above the average (EUR 63 bn in March 2013).
- Issuance of bank debt securities picked up strongly in the first quarter of 2013 by reaching the highest level since 2009.
- Partly fuelled by the investor demand banks in Germany have improved their liquidity positions.

Gross non-bank corporate debt issuance

Cumulative issuance volume, EUR bn

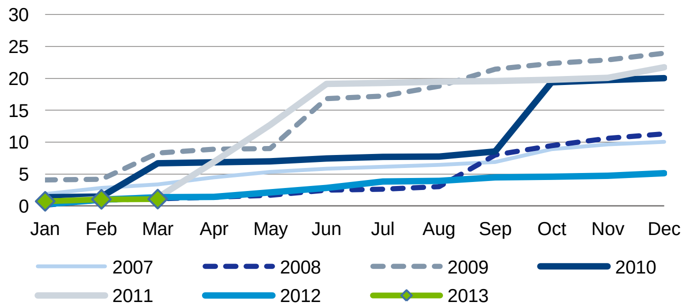


Sources: Bundesbank, DB Research

- Corporate bond issuance was slightly stronger than the previous month with EUR 2.9 bn in March. Still, corporate demand for debt financing remained rather subdued.
- Corporate bond issuance stayed in a lull for the first quarter with the lowest issuance since 2009 (EUR 6.3 bn).
- The low issuance activity in Q1 on the other hand is not entirely surprising as it may reflect the pre-funding effect for 2013 which took place in Q4 2012.

Gross equity issuance

Cumulative issuance volume, EUR bn



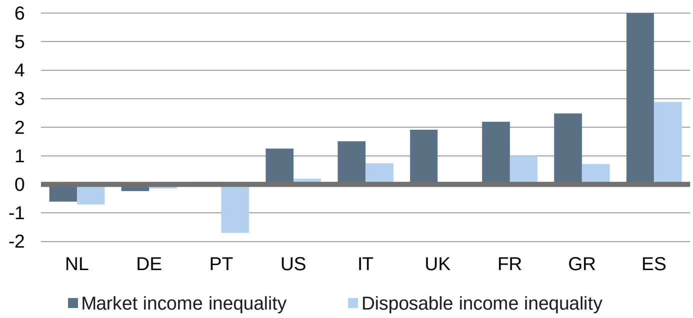
Sources: Bundesbank, DB Research

- With a value of EUR 40 m, the amount raised by companies from equity capital markets in March was the lowest in six years.
- The equity issuance in the first quarter was also the lowest of the last six years with EUR 1.1 bn.

Chartbook: Economic policy

Impact of crisis on income distribution

Percentage point changes in the Gini coefficient* of household market and disposable incomes between 2007 and 2010



* The coefficient is 0 when all have the same, 1 when one has all the income.

Source: OECD

— In Germany the financial market and economic crisis has hardly affected the distribution of private household income – at least not in the first few years. Between 2007 and 2010 the Gini coefficient of household market income as well as of disposable income even decreased slightly by 0.2 pps and 0.1 pp to 49.2 and 28.6 respectively. These figures also demonstrate that due to redistribution via taxes and transfers the disposable income is distributed much more evenly than market income and that the crisis has not changed this.

— In many other countries, especially in Spain and Greece, the inequality of market income distribution increased substantially primarily as a result of higher unemployment. Redistribution policy was able to compensate this by a good deal, but not completely.

Tax load and Social Security Contributions in Germany

Average household net income* EUR	Income Tax	Social Security	VAT	Total Tax Load
	as % household income			
10,024	4.8	8.3	9.2	22.3
13,780	4.7	12.4	8.5	25.5
16,649	6.7	15.3	8.4	30.4
19,257	8.3	16.3	8.3	32.8
21,772	10.1	16.8	8.0	34.8
24,501	11.5	16.5	7.8	35.9
27,629	13.1	16.3	7.6	37.0
31,851	15.1	15.0	7.3	37.4
38,625	18.0	13.2	6.8	38.1
59,133	21.3	8.4	5.8	35.6

* need-weighted average income after Income Tax, VAT and Social Security Contributions

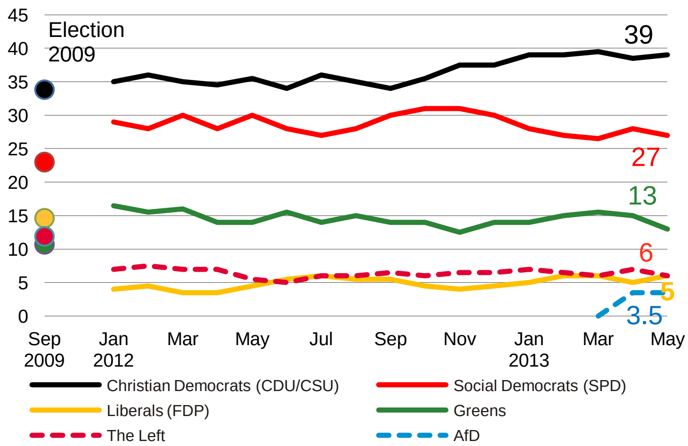
Source: IW Köln

— International comparisons show that the pure tax load in Germany is not above average. The high total tax load results from high Social Security Contributions (SSC). With respect to SSC the burden (relative to the average household net income) is the highest for medium incomes. If one divides the households into ten groups it becomes obvious that the highest total burden (38.1%) arise for the group with an average net household income of EUR 36,625.

— The burden of income tax and VAT rises with higher income (in absolute and relative terms). This is result of the progressive income tax rate. The increasing burden here is stronger than the slightly regressive impact generated by the VAT due to declining consumption ratio. In relative terms the charge to SSC is lower for high incomes, among other things, due to the threshold for income subject to SCC.

Deutscher Bundestag, if elections were held tomorrow

2009 election results, from 2011 onwards survey results, %



Source: IFD Allensbach

— After SPD and Greens published their manifesto for the federal election the SPD was able to assert its results in opinion polls. The range of poll results is between 24% and 29%. The Greens, however, lost ground (-2 pps to 13%). This suggests that the proposed tax hikes do not meet the expectations of all potential voters of the Greens. In fact 53% of all respondents believe that the tax hikes harm their chances to score in the elections.

— Chancellor Angela Merkel is still more popular than her challenger Peer Steinbrück. But recent polls show that a CDU/CSU-led government (47%) is currently welcomed only slightly more than a SPD-led government (43%).

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Germany: Events of economic-, fiscal- and euro-politics

Date	Event	Remarks
6 June	Meeting of the ECB Council, press conference	Review of the monetary policy stance.
11/12 June	Hearing at the German Constitutional Court on the constitutional complaints against the ECB's secondary market programmes and Germany's participation in ESM	The judgment will be held later in summer. It will most likely be in line with the constructive approach of former judgments that provided that (1) the Court will not comment on the ECB's monetary policy and (2) any major decision taken by intergovernmental mechanisms such as EFSF and ESM needs to be legitimized by the German legislative.
17/18 June	G8 leader summit in the UK (Northern Ireland)	The G8 will focus on global economic growth, on open economies, open governments and open societies to support free trade, and on measures to tackle tax evasion.
20/21 June	ECOFIN and Eurogroup in Luxembourg	Agenda is likely to include: European Semester – discussion on Stability and Convergence programmes and euro area specific recommendations, including implications of the spring forecast for excessive deficit procedures and possibly excessive imbalance procedures for euro area countries; latest reviews of the Greek, Irish, Portuguese and Spanish loan programmes.
23 June	Meeting of the CDU/CSU party executive committee	Decision on the party's election manifesto. On June 24 the party leaders will present the manifesto to the public.
27/28 June	European Council – EU leaders' summit in Brussels	Country-specific recommendations on economic policy.
4 July	Meeting of the ECB Council, press conference	Review of the monetary policy stance.
4/5 July	Meeting of the federal electoral committee	Decision on the admission of new/smaller parties to the federal election on Sept. 22. Among others the AfD will most likely be registered.
19/20 July	Meeting of the G20 Finance Ministers and Central Bank Governors in Moscow	
1 August	Meeting of the ECB Council, press conference	Review of the monetary policy stance.

Source: DB Research

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Germany: Data calendar

Date	Time	Data	Reporting period	DB forecast	Last value
6 Jun 2013	12:00	New orders manufacturing (Index, sa), pch mom	April	0.6	2.2
7 Jun 2013	12:00	Industrial production (Index, sa), pch mom	April	0.3	1.2
7 Jun 2013	8:00	Trade balance (EUR bn, sa)	April	17.1	17.6
7 Jun 2013	8:00	Merchandise exports (EUR bn, sa), pch mom (yoy)	April	-2.1 (-0.6)	0.5 (0.5)
7 Jun 2013	8:00	Merchandise imports (EUR bn, sa), pch mom (yoy)	April	-2.0 (-2.2)	0.7 (-4.3)
20 Jun 2013	9:30	Manufacturing PMI (Flash)	June	50.0	49.4
20 Jun 2013	9:30	Services PMI (Flash)	June	50.5	49.8
24 Jun 2013	10:30	ifo business climate (Index, sa)	June	106.5	105.7
27 Jun 2013	10:00	Unemployment rate (%, sa)	June	7.0	6.9
28 Jun 2013	14:00	Consumer prices preliminary (Index, sa), pch mom (yoy)	June	-0.2 (1.5)	0.4 (1.5)
28 Jun 2013	8:00	Import prices (Index, sa) pch mom (yoy)	May	-0.2 (-2.7)	-1.4 (-3.2)
28 Jun 2013	8:00	Retail sales (Index, sa), pch mom	May	0.8	-0.4
14 Aug 2013	8:00	Real GDP (Index, sa), % qoq	Q2 2013	0.5	0.1

Sources: DB Research, Federal Statistical Office, Federal Employment Agency, ifo, Markit

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Financial forecasts

	US	JP	EMU	GB	CH	SE	DK	NO	PL	HU	CZ
Key interest rate, %											
Current	0.13	0.10	0.50	0.50	0.00	1.00	0.20	1.50	3.00	4.50	0.05
Jun 13	0.13	0.10	0.50	0.50	0.00	1.00	0.30	1.50	2.50	3.75	0.05
Sep 13	0.13	0.10	0.25	0.50	0.00	1.00	0.40	1.50	2.50	3.50	0.05
Mar 14	0.13	0.10	0.25	0.50	0.00	1.25	0.50	1.75	2.50	3.50	0.05
3M interest rates, %											
Current	0.28	0.23	0.20	0.51							
Jun 13	0.35	0.30	0.25	0.51							
Sep 13	0.35	0.30	0.25	0.52							
Mar 14	0.35	0.30	0.30	0.60							

10J government bonds yields

	Yields, %				Spreads vs. EMU, pp			
Current	2.19	0.88	1.47	1.96	-0.78	0.40	0.06	0.71
Jun 13	1.50	0.70	1.40	2.25	-0.70	0.25	0.25	0.65
Sep 13	2.00	0.80	1.55	2.45	-0.65	0.20	0.30	0.70
Mar 14	3.00	0.90	1.85	2.90	-0.65	0.20	0.30	0.75

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	1.30	100.45	0.85	1.52	1.24	8.57	7.46	7.61	4.29	296.11	25.71
Jun 13	1.26	103.00	0.87	1.61	1.25	8.20	7.46	7.30	4.06	284.00	25.20
Sep 13	1.23	106.00	0.86	1.56	1.25	8.00	7.46	7.20	4.01	280.00	25.20
Mar 14	1.20	110.00	0.85	1.49	1.25	7.80	7.46	7.10	4.00	280.00	25.03

Sources: Bloomberg, Deutsche Bank

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German data monitor

	Q2 2012	Q3 2012	Q4 2012	Q1 2013	Q2 2013	Dec 2012	Jan 2013	Feb 2013	Mar 2013	Apr 2013	May 2013
Business surveys and output											
Aggregate											
Ifo business climate	107.1	102.3	101.4	106.1		102.5	104.3	107.4	106.7	104.4	105.7
Ifo business expectations	100.1	94.3	95.6	103.0		98.1	100.7	104.6	103.6	101.6	101.6
PMI composite	49.3	47.9	49.1	52.8		50.3	54.4	53.3	50.6	49.2	49.9
Industry											
Ifo manufacturing	102.5	96.4	95.1	101.1		96.3	99.1	102.4	101.9	99.3	100.7
PMI manufacturing	45.5	45.0	46.3	49.7		46.0	49.8	50.3	49.0	48.1	49.4
Headline IP (% pop)	0.0	0.2	-2.6	0.2		0.2	-0.6	0.6	1.2		
Orders (% pop)	-0.4	-1.7	1.0	0.4		1.1	-1.6	2.2	2.2		
Capacity Utilisation	84.9	83.7	82.1	83.2	82.7						
Construction											
Output (% pop)	2.6	0.5	-2.3	-6.2		-6.5	-0.5	-0.3	-4.5		
Orders (% pop)	-5.2	-1.3	2.1	2.6		0.8	9.5	4.4	-5.5		
Ifo construction	120.0	118.0	117.6	125.6		118.8	122.7	127.0	127.2	124.5	123.6
Services											
PMI services	51.3	49.4	50.0	53.8		52.0	55.7	54.7	50.9	49.6	49.8
Consumer demand											
EC consumer survey	-1.1	-7.9	-10.0	-6.5		-10.4	-7.6	-6.4	-5.4	-4.9	-4.5
Retail sales (% pop)	1.1	-0.8	-0.7	1.5	-0.7	-2.1	3.1	-0.8	-0.1	-0.4	
New car reg. (% yoy)	0.2	-7.0	-6.2	-10.5		-16.4	0.0	-10.5	-17.1	3.8	
Foreign sector											
Foreign orders (% pop)	0.1	-1.0	2.2	-1.0		1.6	-2.7	2.1	2.7		
Exports (% pop)	1.2	1.2	-2.0	0.4		0.4	1.6	-1.2	0.5		
Imports (% pop)	-0.2	0.2	-0.8	-1.4		-1.5	3.3	-3.9	0.7		
Net trade (sa EUR bn)	47.8	50.6	46.9	51.2		16.9	15.9	17.7	17.6		
Labour market											
Unemployment rate (%)	6.8	6.8	6.9	6.9		6.9	6.9	6.9	6.9	6.9	6.9
Change in unemployment (k)	15.3	19.0	30.0	-5.0		2.0	-13.0	2.0	12.0	6.0	21.0
Employment (% yoy)	1.2	1.0	0.9	0.7		0.8	0.6	0.8	0.7	0.7	
Ifo employment barometer	107.4	105.9	106.3	106.2		107.6	105.8	106.5	106.4	104.7	105.6
Prices, wages and costs											
Prices											
Harmonised CPI (% yoy)	2.1	2.1	2.0	1.8		2.0	1.9	1.8	1.8	1.1	1.7
Core HICP (% yoy)	1.4	1.2	1.3	1.4		1.5	1.1	1.3	1.8	0.6	
Harmonised PPI (% yoy)	2.0	1.4	1.5	1.1		1.5	1.7	1.2	0.4	0.1	
Commodities, ex. Energy (% yoy)	-7.8	-4.5	0.7	-3.5		1.1	-3.7	-3.2	-3.7	-6.2	
Oil price (USD)	108.2	109.7	110.1	112.6		109.4	113.1	116.3	108.4	102.0	
Inflation expectations											
EC household survey	25.0	27.0	31.2	26.6		31.2	27.6	26.5	25.6	25.4	21.6
EC industrial survey	6.4	0.8	2.9	3.7		4.6	5.4	3.2	2.5	-0.4	-1.8
Unit labour cost (% yoy)											
Unit labour cost	2.8	3.3	3.2	4.1							
Compensation	2.4	2.5	2.8	2.4							
Hourly labour costs	3.2	3.5	3.8	4.3							
Money (% yoy)											
M3	7.0	6.8	6.0	5.3		6.0	6.1	5.8	5.3	5.6	
M3 trend (3m cma)						6.8	6.0	5.7	5.6		
Credit – private	0.7	0.6	-0.4	-0.2		-0.4	-0.3	-0.2	-0.2		
Credit – public	22.0	10.4	13.5	-18.7		13.5	-5.4	-13.0	-18.7		

% pop = % change this period over previous period.
Sources: Deutsche Bundesbank, European Commission, Eurostat, Federal Employment Agency, German Federal Statistical Office, HWWI, ifo, Markit

Deutsche Bank
DB Research

Focus Germany

Focus Germany is part of the Current Issues series and deals with macroeconomic and economic policy issues in Germany. Each issue also contains a timetable of financial and economic policy events as well as a detailed data monitor of German economic indicators. Focus Germany is a monthly publication.

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