Deutsche Bank
Research

Focus Germany

October 4, 2018

Increasing headwinds but fiscal surplus (still) rising

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

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

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

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

Jochen Möbert
+49 69 910-31727
jochen.moebert@db.com

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

Editor
Stefan Schneider

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

www.dbresearch.com

DB Research Management
Stefan Schneider

Content Page

Forecast tables 2
Weak currencies and economic difficulties in emerging markets dampen German exports 3
2019 budget and fiscal plan up to 2022 8
The View from Berlin. Upcoming regional elections will likely create further headwinds for Merkel and the Groko government 17
DB German Macro Surprise Index 19
Event calendar 20
Data calendar 20
Financial forecasts 21
Data monitor 22

Weak currencies and economic difficulties in emerging markets dampen German exports. Over the past few months, the euro has appreciated against the currencies of many emerging markets which will likely curtail German exports to these countries in 2018 and 2019. In 2017, the ten largest German export markets among the emerging markets accounted for some 16% of total exports. According to our estimation model, German exports to this country group are set to increase by a nominal 3.5% to 4% in 2018 and 2019. This would be a noticeable loss of momentum compared with 2017 when exports increased by just over 7%. The country group's share of total exports for the industrial sector is highest for traditional capital goods manufacturers, with mechanical engineering taking the lead. The ten emerging economies examined accounted for just over 22% of all exports in this sector in 2017.

2019 budget and fiscal plan up to 2022. Given stronger fiscal developments, we now expect Germany's general government fiscal surplus to widen to 1.4% of GDP in 2018 before decreasing to 1.1% in 2019. Hence, the debt ratio could fall below 60% of GDP already in 2018. Still, we expect a pro-cyclical shift in fiscal policies. The federal government's structural deficit should widen to EUR 15.6 bn in 2019 from EUR 5.5 bn in 2018 and social transfers will likely rise further. The planned depletion of the asylum reserve will allow adherence to the provisions by the debt brake and achieving a "black zero". The government's wide use of special budgetary instruments (like reserves, off-budget entities and global provisions) leads to a lack of clarity and moreover complicates tracing the government's budget and fiscal planning.

The view from Berlin. Upcoming regional elections will likely create further headwinds for Merkel and the Groko government. The likely weak results for the SPD will spark further internal debates. The widely expected loss of the CSU majority in Bavaria might trigger a reshuffle of CSU cabinet posts in Berlin: Forming coalitions will take some time, and thus slow political decision-making in Germany down. However, if the CSU is forced to establish a center-left or center-green coalition government in Munich, it might be forced to act more constructively in Berlin too, e.g. with regard to the asylum policy and European policy issues. In the likely event of a meagre outcome for the CDU in Hesse, Chancellor Merkel's power will erode further.

Increasing headwinds but fiscal surplus (still) rising

Economic forecasts

	Real GDP (% growth)			Consumer Prices* (% growth)			Current Account (% of GDP)			Fiscal Balance (% of GDP)		
	2017	2018F	2019F	2017	2018F	2019F	2017	2018F	2019F	2017	2018F	2019F
Euroland	2.5	2.0	1.7	1.5	1.8	2.0	3.5	3.1	2.5	-0.9	-0.8	-0.7
Germany	2.2	1.9	1.7	1.8	1.6	1.8	7.9	7.3	6.4	1.0	1.4	1.1
France	2.3	1.6	1.5	1.2	2.2	1.7	-0.6	-0.4	-0.4	-2.7	-2.5	-3.0
Italy	1.6	1.1	0.9	1.3	1.5	2.0	2.9	2.5	2.3	-2.3	-2.1	-1.8
Spain	3.0	2.6	2.4	2.0	1.8	1.8	1.8	1.4	1.2	-3.1	-2.5	-1.6
Netherlands	2.9	2.7	2.2	1.3	1.6	2.1	10.5	10.3	9.9	1.1	0.8	0.6
Belgium	1.7	1.6	1.8	2.2	2.3	2.3	0.7	0.0	0.0	-1.0	-1.2	-1.2
Austria	3.1	3.0	2.2	2.2	2.0	1.8	2.0	2.3	2.4	-0.7	-0.3	0.0
Finland	2.8	2.7	2.1	0.8	1.3	1.5	-0.7	0.5	0.5	-0.6	-0.4	-0.2
Greece	1.3	2.1	2.1	1.1	0.7	1.3	-1.0	-0.5	-0.3	0.8	0.9	0.5
Portugal	2.8	2.2	1.7	1.6	1.5	1.9	0.7	0.2	0.2	-3.0	-1.0	-0.8
Ireland	7.2	6.6	3.8	0.3	0.8	1.4	8.5	7.5	6.5	-0.3	0.2	-0.2
UK	1.7	1.3	1.6	2.7	2.4	2.0	-3.7	-3.7	-3.4	-1.8	-1.7	-1.4
Denmark	2.3	1.8	1.8	1.1	1.0	1.3	7.5	7.4	7.3	0.9	-0.4	-0.4
Norway	2.4	2.1	2.0	1.9	2.0	2.0	5.6	6.0	6.0	5.1	4.5	4.6
Sweden	2.4	2.6	2.4	1.8	1.7	1.8	3.3	3.8	3.9	1.4	1.0	0.9
Switzerland	1.7	3.0	1.7	0.5	1.0	0.9	9.5	9.9	10.1	0.6	0.5	0.4
Czech Republic	4.5	3.4	3.1	2.5	2.1	2.3	1.0	0.6	0.6	1.6	0.5	0.3
Hungary	4.0	4.1	3.3	2.3	2.8	3.2	3.1	1.9	1.5	-2.0	-2.2	-2.1
Poland	4.6	4.4	3.6	1.9	1.8	2.5	0.2	-0.8	-1.0	-1.6	-1.9	-2.2
United States	2.2	2.9	2.8	2.1	2.6	2.4	-2.3	-2.7	-3.5	-3.4	-3.9	-4.5
Japan	1.7	0.9	0.6	0.5	0.8	0.3	4.0	3.8	4.1	-2.8	-2.6	-2.3
China	6.9	6.6	6.3	1.6	2.0	2.4	1.3	0.6	0.3	-3.7	-3.5	-3.5
World	3.8	3.8	3.7	2.9	3.3	3.5						
	3.1	3.5	3.9	4.2	5.1	4.4						

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

Sources: National Authorities, Deutsche Bank

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

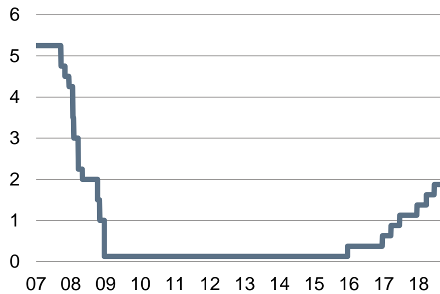
					2018				2019			
	2016	2017	2018F	2019F	Q1	Q2	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Real GDP	2.2	2.2	1.9	1.7	0.4	0.5	0.4	0.5	0.5	0.4	0.4	0.4
Private consumption	2.1	1.8	1.6	1.4	0.5	0.3	0.4	0.4	0.4	0.4	0.3	0.2
Gov't expenditure	4.0	1.6	1.2	1.4	-0.3	0.6	0.8	0.4	0.3	0.3	0.3	0.3
Fixed investment	3.5	2.9	3.1	2.9	1.4	0.5	0.9	0.8	0.9	0.8	0.8	0.7
Investment in M&E	2.3	3.7	4.5	2.6	2.3	0.3	0.5	0.5	1.0	0.7	0.7	0.5
Construction	3.8	2.9	3.5	4.1	1.6	0.6	1.2	1.2	1.0	1.0	1.0	1.0
Inventories, pp	0.2	0.1	0.2	0.0	-0.1	0.4	-0.1	0.0	0.0	0.0	0.0	0.0
Exports	2.3	4.6	3.1	4.2	-0.3	0.7	1.0	1.2	1.1	1.0	1.0	1.0
Imports	4.1	4.8	3.8	4.9	-0.2	1.7	1.2	1.3	1.2	1.2	1.1	1.0
Net exports, pp	-0.5	0.2	-0.1	-0.1	0.0	-0.4	0.0	0.0	0.0	0.0	0.0	0.1
Consumer prices*	0.5	1.8	1.6	1.8								
Unemployment rate, %	6.1	5.7	5.2	4.9								
Industrial production	1.4	3.0	1.8	1.5								
Budget balance, % GDP	0.9	1.0	1.4	1.1								
Public debt, % GDP	67.9	63.9	59.9	56.3								
Balance on current account, % GDP	8.5	7.9	7.3	6.4								
Balance on current account, EUR bn	268.8	257.7	250	225								

*Inflation data for Germany based on national definition. This can lead to discrepancies to other DB publications.

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

Federal funds rate on the rise 1

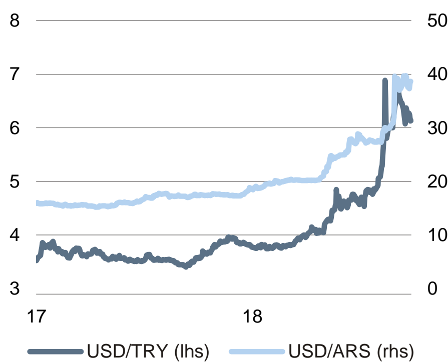
US federal funds rate, %



Source: Fed

USD appreciates against Turkish lira and Argentine peso 2

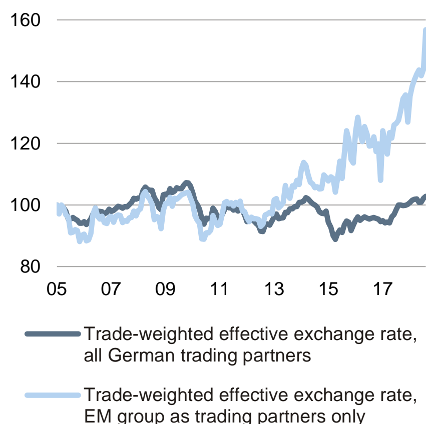
USD exchange rate against Turkish lira and Argentine peso



Source: IHS Markit

Euro is trending up against currencies of emerging markets 3

Nominal trade-weighted effective EUR exchange rate, Jan. 2005=100



Sources: ECB, Deutsche Bank Research

Weak currencies and economic difficulties in emerging markets dampen German exports

— Over the past few months, the euro has appreciated against the currencies of many emerging markets which will curtail German exports to these countries in 2018 and 2019.

— In 2017, the ten largest German export markets among the emerging markets accounted for some 16% of total exports. According to our estimation model, German exports to this country group are set to increase by a nominal 3.5% to 4% in 2018 and 2019. This would be a noticeable loss of momentum compared with 2017 when exports increased by just over 7%.

— The country group's share of total exports for an industrial sector is highest for traditional capital goods manufacturers with mechanical engineering taking the lead. The ten emerging economies examined accounted for just over 22% of all exports in this sector in 2017. Electrical engineering (19.4%) and the automotive industry (18.3%) also recorded above-average export shares. Industry-specific factors dampen the exchange rate effect.

US turnaround in interest rates and other factors put currencies in emerging economies under pressure

The currencies of many emerging markets have come under pressure in recent months. There are several reasons for this: one is the quarterly interest rate hikes of the US Federal Reserve lately. The excellent economic data also implies that further rate changes are to come there. For 2018, we expect another rate hike (i.e. a total of four increases during the year as a whole) as well as another four interest rate changes in 2019. Other factors include trade policy conflicts between the US and countries such as China, Turkey or Russia. US import duties are curbing economic growth in the countries concerned. These factors are prompting investors to withdraw funds from emerging markets and instead invest them increasingly in the US. The extremely negative impact of the new US trade policy on global sentiment indicators is more significant. Furthermore, we are well advanced in the global economic cycle and investors are likely to look for “safe havens” like the US dollar in an economic downturn, too. After all, emerging economies are at risk in both scenarios – a continued US upswing and a recession – of strong turbulence and less favorable judgements from the rating agencies.

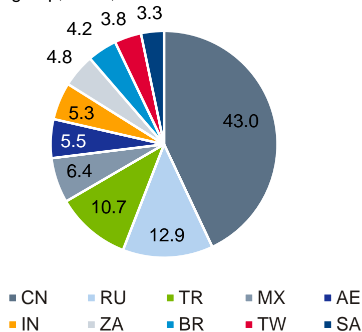
The issue of capital outflows from the emerging economies might be worsened by economic or political problems of their own making at home. Uncertainties due to forthcoming elections, unfavorable conditions for investment or political influence on the decisions of the respective central banks mean that investors are being cautious. Furthermore, a large share of company debt in emerging markets is denominated in foreign currencies like the US dollar. An increase in the value of the US dollar may accelerate cash outflows because this impairs the debt sustainability of the companies concerned. In general, spillover effects from one emerging economy to another are not unusual although their economic growth, competitiveness, monetary policy, inflation, and political stability vary considerably.

Overall, emerging economy currencies have depreciated considerably. A basket of various emerging economy currencies (the Emerging Markets Currency Index) has fallen by more than 10% against the US dollar since the start of 2018 while individual currencies like the Turkish lira or the Argentinian peso have even yielded around 70%.

Emerging economies important for the German export economy

China most important German export market in EM group 4

Share of countries in total German goods exports to EM group, 2017, %



Sources: Federal Statistical Office, Deutsche Bank Research

Emerging economy currencies have not only depreciated against the US dollar. They have also lost against the euro on average. Naturally, this has also impacted the German export economy though not every emerging market currency has lost against the euro. And not every emerging economy with a currency that has depreciated is really important for the German economy. However, the impact is noticeable overall.

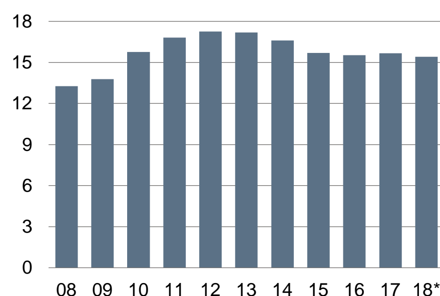
In order to quantify this effect, we have used the ten largest German export markets among the emerging economies outside Europe (but including Russia) as a basis. The top 10 are (in order of German goods exports in 2017) China, Russia, Turkey, Mexico, the United Arab Emirates, India, South Africa, Brazil, Taiwan and Saudi Arabia. This means that countries like Argentina have been left out, despite the sharp currency depreciation because they are less relevant to the German export industry. By contrast, we take Saudi Arabia into account although the country has had its currency tied to the US dollar for many years.

The country group mentioned accounted for just under 16% of all German exports of goods in 2017. Over the past ten years, this share has ranged from just over 13% (2008) to just over 17% (2012). In 2017, China was the most important single export market in this emerging markets group (EM group) with a share of 43%, followed by Russia (just under 13%) and Turkey (10.7%). From 2008 to 2017, German exports of goods to the EM group increased nominally by just over 53%. This increase was significantly higher than growth in total German exports in the same period (some +30%). The weighted real GDP growth of these countries between 2010 and 2017 was an average of +5.6% per year (based on purchasing power parities), significantly exceeding global economic growth (+3.5% p.a.).

Depreciation of currencies of key German trading partners

Export share of EM group quite stable of late 5

Share of EM group in total German goods exports, %



* January till July

Sources: Federal Statistical Office, Deutsche Bank Research

We have calculated a trade-weighted exchange rate from the currencies of these countries against the euro. The euro has gained 25% against this currency basket since the start of 2018 and was up almost 37% on the level seen at the start of 2017.

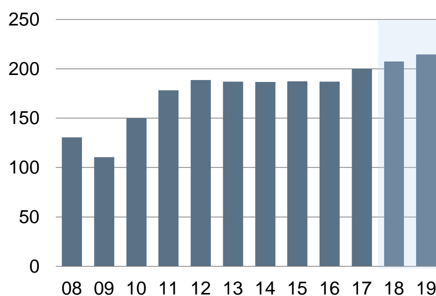
Exchange rate fluctuations had a noticeable impact on German exports to the EM group. For example, German exports to these countries rose between 2008 and 2012 by just over 44% in nominal terms while total German exports during this period only increased by 11%. The sharp increase was driven by the fact that the euro lost around 3% of its value against the EM group's currency basket (based on annual averages). The situation in the period between 2012 to 2017 was the opposite when the increase in goods exported to the EM group by just over 6% in nominal terms, lagged significantly behind the pace of growth in exports overall (+17%). During this period, the euro appreciated against the currency basket by some 32% while the total German trade-weighted exchange rate increased by just under 4%.

Of course, the trend in German exports is influenced by a large number of factors in addition to the exchange rate. These include economic growth in the respective export markets as well as the trade policy environment. The EU sanctions against Russia in the above-mentioned time period between 2012 and 2017 can serve as an example here. These sanctions contributed to German exports of goods to Russia in 2017 being just over 32% below the level of 2012. Furthermore, German exports are impacted by commodity prices. This primarily applies to exports to those countries in the EM group with an economic model based significantly on the export of commodities (in addition to Russia, specifically Saudi Arabia as well as the United Arab Emirates, Brazil and South

Africa). One example of this is the reduced German exports of goods to Saudi Arabia in 2016 when the oil price was far below the long-standing average, by almost 27%. One example of this is the reduced German exports of goods to Saudi Arabia in 2016 when the oil price was far below the long-standing average, by almost 27%.

German exports to emerging markets grow moderately 6

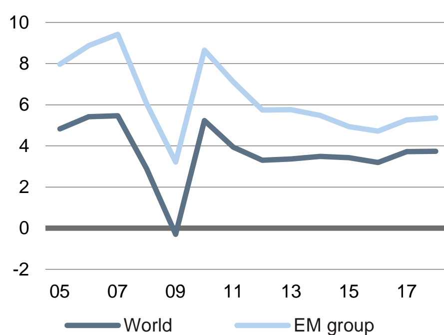
German goods exports to EM group, EUR bn



Sources: Federal Statistical Office, Deutsche Bank Research

GDP growth in emerging markets above average 7

Real GDP (based on PPP), % yoy



Sources: IHS Markit, Deutsche Bank Research

Our estimation models imply high negative exchange rate effects

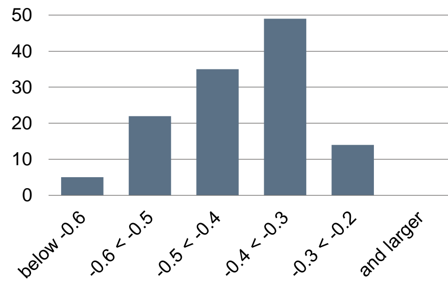
We use a simple export model to explain exchange rate and demand elasticities in the period between Q2/2008 and Q4/2017. In our model, the growth of German exports to the EM country group is explained by the exchange rate growth and the economic growth of the EM countries.1Due to the major differences between the countries, we have estimated various model specifications – known as "thick modelling" – to reduce any model uncertainties. The export model is estimated both as an individual equation for the entire EM set and applying a panel approach with individual input data for all ten countries. We then estimated several specifications for both types that differ among other things in the periods examined or the estimation method. Overall, 132 model specifications have been calculated that deliver a range of estimated elasticities with only statistically significant elasticities being taken into account for interpretation (see figures 8 and 9 for more information).

The coefficients for our estimated elasticities show the expected negative and positive signs: first, an appreciation of the euro is curtailing German exports to the EM group. The exchange rate elasticities estimated range between -0.6 and -0.3 with the median less prone to outliers at -0.5. This elasticity indicates the percentage by which German export growth increases if the euro loses 1% against our EM exchange rate. German exports to the EM group rose by 6% between 2012 and 2017 in nominal terms. Without the appreciation of the euro against the EM currencies by 32%, export growth would have amounted to 22% (ceteris paribus; the negative FX effect equals 32% x 0.5). Our estimates suggest a positive demand elasticity depending on the GDP growth of the EM countries. The demand elasticity we estimate ranges from +0.7 to +9.0. The strong heterogeneity of the coefficients can be explained by the development of the individual EM economies as well as political incidents and sanctions. The median for our demand elasticities is +2.7.

In 2018, development in export growth was very uneven. From January to July, exports increased overall by just over 4% compared with the same period in 2017. For full-year 2018, we expect – given our model elasticities – nominal export growth of 3.5% (2017: +7%). This forecast is based on two assumptions: firstly, a depreciation of the EM currencies by 20% for full-year 2018 (which implies no further depreciation for the rest of 2018) and secondly real GDP growth of 5% in our EM group with this based on the weighted aggregate of the DBR forecasts for each EM country. The same approach for 2019 implies that growth in German exports to the EM group will increase by 3.8%, again based on a marked depreciation of 20% and aggregate GDP growth according to our forecasts of around 5% in real terms. By contrast, assuming easing pressure and no further depreciation of the EM currencies in 2019, exports to the EM group could increase much more at over 8% nominally in 2019 (in other words even more than in 2017, when the euro appreciated against the EM currencies by 4.4% yoy on average).

Exchange rate effects on German exports solely negative 8

Distribution of exchange rate coefficients, rel. frequency

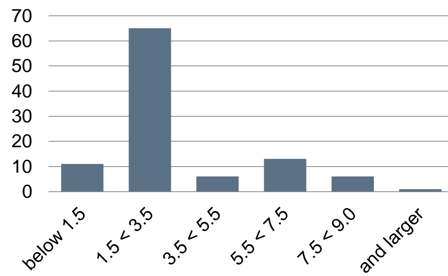


The dependent variable is the percentage change of German exports to our EM country group. As explanatory variables the exchange rate growth and the economic growth of the EM countries as well as seasonal effects are used. Overall, 132 model specifications were calculated with only statistically significant elasticities being displayed. The median coefficient for our estimated exchange rate elasticities lies at -0.5.

Sources: ECB, IHS Markit, IMF, Federal Statistical Office, Deutsche Bank Research

Positive demand effects for German exports from emerging countries 9

Distribution of gross domestic product coefficients, rel. frequency

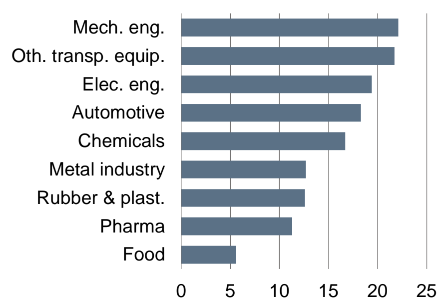


The dependent variable is the percentage change of German exports to our EM country group. As explanatory variables the exchange rate growth and the economic growth of the EM countries as well as seasonal effects are used. Overall, 132 model specifications were calculated with only statistically significant elasticities being displayed. The median coefficient for our estimated exchange rate elasticities lies at +2.7.

Sources: ECB, IHS Markit, IMF, Federal Statistical Office, Deutsche Bank Research

Emerging markets important for German investment goods producers 10

Share of EM group in total goods exports by sector, 2017, %



Sources: Federal Statistical Office, Deutsche Bank Research

High emerging market exposure in the capital goods industries

The EM group is important for German industry sectors to different degrees. In a long-term comparison (2008 to 2017) of all the sectors examined, exports to the selected emerging markets increased faster than total exports in the respective industry. The country group's share of total exports for an industry is highest for traditional capital goods manufacturers with mechanical engineering taking the lead. The ten emerging economies examined accounted for just over 22% of all exports in this sector in 2017. In electrical engineering (19.4%) and the automotive industry (18.3%), the EM group's share of total exports is also above the average of the entire manufacturing sector. It is interesting to note that the shares of exports accounted for by the automotive industry (23.1% in 2012) and mechanical engineering (2011: 27.3%) were once much higher than is currently the case. This lower significance is primarily due to decreases in exports to Russia since 2012 and only slight growth in exports to China.

In the German chemicals industry, the EM group's share of exports in recent years has been relatively constant at between 16% and 17%. It is much more volatile for other transport equipment. This is mainly because aircraft deliveries to the United Arab Emirates can vary greatly from year to year. To cite an example: the EM group accounted for more than 21% in this industrial sector in 2017 but only 16.4% in the first seven months of 2018. Out of all the export-reliant sectors in Germany, the EM group is of the least importance to the pharmaceutical industry. The export share here in 2017 was just over 11% only. In the food sector, which is primarily focused on the German market in any case, it only amounted to 5.6%.

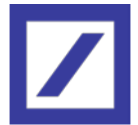
Exchange rate effects relevant but also softened by industry-specific factors

In all the industry sectors examined, there has been a negative correlation over the last ten years between the rates of change in exports to the EM group and the euro exchange rate against the currency basket (in each case compared with the previous year and on a monthly basis). A strong euro impacts exports to the emerging markets concerned – as was also to be expected. The most recent depreciation of emerging economy currencies will thus – as outlined above – impact exports to the EM group in 2018 and 2019. Nevertheless, there are a range of industry-specific factors that soften exchange rate effects:

— In the automotive industry, production abroad and intragroup trade play a major role. The Chinese auto market in particular is largely served by the local production of German companies. Another factor is the focus of the German automotive industry on the premium segment. Here the price elasticity of demand is lower than in the volume segment. Furthermore, in the automotive industry, exchange rate changes do not generally lead directly to price adjustments in the foreign sales market. Instead, pricing is driven by local conditions (current supply and demand, competition). Changes in exchange rates are more likely to impact the return per vehicle that the respective auto manufacturer can generate than absolute exports.

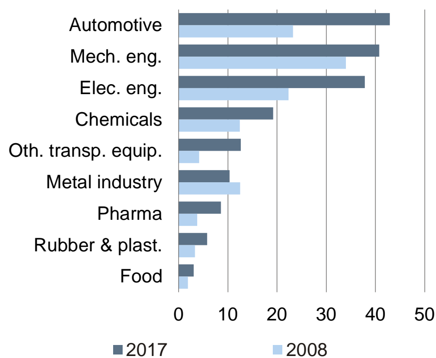
— In mechanical engineering and some areas of electrical engineering, the focus is on high quality specialized machinery and/or electrical capital goods. The price elasticity of demand is also lower here than in the case of standard machinery or simple electronic consumer goods.

— The chemicals industry is export-reliant but compared with the automotive industry or mechanical engineering, a larger proportion of chemical trade is conducted within European production networks. Furthermore, localisation



Automotive and mech. eng. most important exporters to EM group 11

German goods exports to EM group by sector, EUR bn



Sources: Federal Statistical Office, Deutsche Bank Research

of production in the chemical industry has also increased over the past few years.

— In the pharmaceuticals industry, the price elasticity of demand is low for many products. By contrast, generic drugs are affected much more by exchange rate fluctuations.

— A unique characteristic of other transport equipment (primarily aircraft) is that the global aircraft market is a US dollar market but the majority of costs for the German industry are in euro. Furthermore, discounts are common, especially with bulk orders, which can significantly exceed the effect of exchange rate changes.

Eric Heymann (+49 69 910-31730, eric.heymann@db.com)
Jochen Möbert (+49 69 910-31727, jochen.moebert@db.com)

The authors would like to thank Marcel Stechert for his contribution to this article.

2019 budget and fiscal plan up to 2022

— Given stronger fiscal developments, we now expect Germany's general government fiscal surplus to widen to 1.4% of GDP in 2018 before decreasing to 1.1% in 2019. Hence, the debt ratio could fall below 60% of GDP already in 2018. According to the 2018 budget, 2019 budgetary draft and financial plan until 2022, the federal government intends to spend additional money lavishly, primarily on social security and a little bit more on investment.

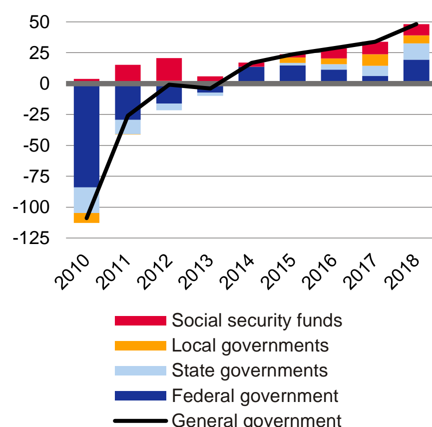
— Although the debt brake argues for some stability of public finances, it will not prevent a pro-cyclical shift in fiscal policies. The visible deterioration of the federal government's structural deficit (to EUR 15.6 bn in 2019 from EUR 5.5 bn in 2018) and higher social transfers, which are set to weigh on the long-term fiscal sustainability, are causes for concern from a perspective of policy stability.

— In light of permanent federal government deficits envisaged for 2018-22, the federal government's fiscal scope appears to be already more or less exhausted. Additional spending in excess of the fiscal plan might be only feasible in the event of positive surprises (e.g. to tax receipts). Given an actual maximum permissible amount of net borrowing under the debt brake of EUR 6.9 bn in 2018 and EUR 4.0 bn in 2019, the scope for new debt appears to be limited, albeit dispensable in view of the fiscal target of a "black zero".

— The government's wide use of special budgetary instruments (like reserves, off-budget entities and global provisions) leads to a lack of clarity and moreover complicates tracing the government's budget and fiscal planning. In addition, the planned depletion of the asylum reserve will enable the government to considerably ease fiscal policies during a boom phase despite adhering to the provisions by the debt brake and achieving a "black zero".

Large consolidated general government budget surplus in H1 2018 | 1

Consolidated general government budget balance, (National Accounts), EUR bn



2018: Preliminary data for the first half of 2018.

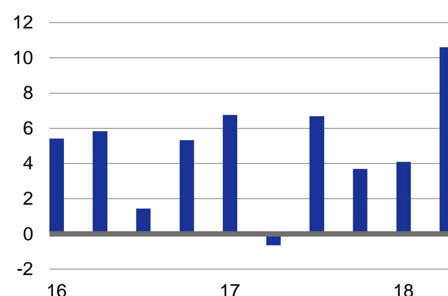
Sources: WEFA, Federal Statistical Office, Deutsche Bank Research

Starting point: Hefty surpluses thanks to full employment, booming taxes and ultra-low interest rates

German public sector budgets continue to benefit from the still-healthy macroeconomic environment (above-potential GDP growth, employment at record highs, ultra-low Bund yields and real ECB tightening as yet in the distant future). Maintaining its robust pace despite external imponderables (US-EU-China trade conflict, crises in some emerging markets such as Turkey, Brexit, fiscal risks in Italy), the German economy remains on a sustained uptrend. With employment at record highs and income (wages) on the uptick, total general government revenues (taxes, social security contributions) are a clear beneficiary. As a nice side effect for Germany's public sector budgets, income tax gains stemming from buoyant growth are further boosted by the progressivity of its tax system, whilst, at the same time, the spending side of the general government budget is clearly benefitting from still-low Bund yields and strongly declining unemployment. Another positive is that the impact of the looming demographic challenge on public finances, which is likely to materialise more noticeably from mid-2025, is not yet being felt ("demographic respite").

Tax revenue (excluding taxes of local communities) | 2

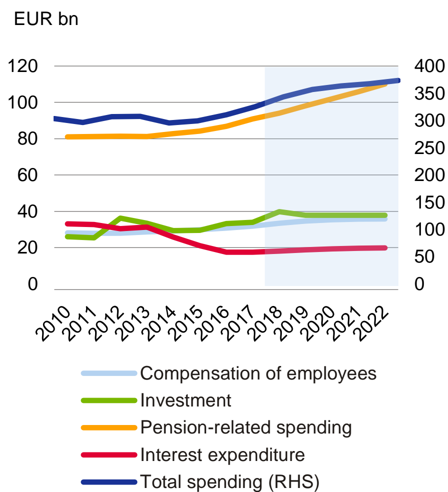
% yoy (based on quarterly data)



Soruces: Deutsche Bundesbank, Deutsche Bank Research

Against this backdrop it does not really come as a surprise that the general government (which includes the federal government, the federal states, the local authorities and the social security system) ran a hefty surplus of EUR 48.1 bn in the first half of 2018, according to provisional data of the Federal Statistical Office. This is equivalent to 2.9% of nominal GDP in H1 (by comparison: 2017:

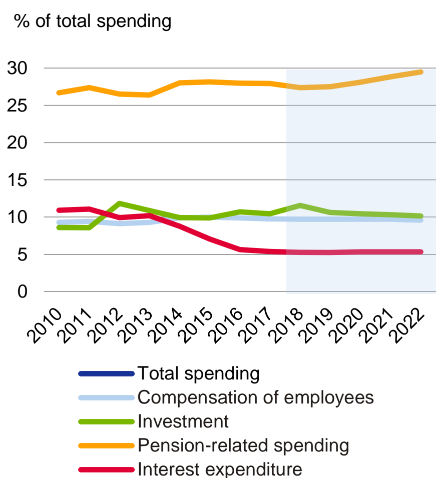
Selected expenditure items (from the 2018 federal budget, 2019 draft budget and financial plan until 2022 3



Investment in 2018: including digitalisation fund.

Sources: Federal Ministry of Finance, Deutsche Bank Research

Federal budget 2018, budgetary draft 2019 and financial plan until 2022 4



Investment in 2018: including digitalisation fund.

Sources: Federal Ministry of Finance, Deutsche Bank Research

EUR 34 bn or 1.0% of GDP). Even though the preliminary results for the first six months provide only limited clues about full-year data, there are hardly any doubts at present that the general government will again record a huge surplus of well over 1% of GDP in 2018 and that, courtesy of buoyant growth, the debtto- GDP ratio looks set to drop below the 60% Maastricht limit still this year, if not by 2019, at the very latest. In the second half of the year, however – following the adoption of the 2018 federal budget, which marks the end of interim budget management in mid-July – government spending is likely to increase visibly. As a result, the federal government surplus would shrink compared with the first six months (H1 2018: EUR 19.5 bn or around 40% of the total general government surplus). In the medium term, macroeconomic fundamentals ought to be favourable for public budgets. But with German spending policy turning increasingly pro-cyclical, surpluses are likely to shrink in the years ahead.

Given stronger fiscal developments we now expect Germany's general government fiscal surplus to widen to 1.4% of GDP in 2018 before decreasing to 1.1% in 2019 (previous forecasts: 1.2% for both 2018/19). Hence, the debt ratio could fall below 60% of GDP already in 2018.

2018/19 federal budget and fiscal plan up to 2022: Government is spending additional money lavishly – primarily on social security and a little bit more on investment

Some of the key measures specified in the coalition treaty (such as the children's allowance for parents who buy or build a home) have already been itemised in the recently adopted 2018 federal budget. Other priority actions (including pensions for mothers II starting from 2019, the partial abolition of the solidarity surcharge starting from 2021, cold progression allowances starting in 2019) are either tackled in the 2019 budget draft or in the fiscal plan up to 2022 adopted on 6 July 2018. Clearly, there is a recurring theme running through the new government's fiscal policy. First, the German government sticks to its promise of previous years that it will not take on new debt in the five years ahead – though this is hardly an ambitious objective, neither in the face of buoyant growth nor from the perspective of the taxpayer. As in the past, a major fiscal target in this context is the so-called "black zero" in the federal core budget, under which the government commits itself to no new net borrowing. The "black zero" has been maintained since 2014. Apart from this fiscal target of the government itself, the debt brake included in the Basic Law argues for some stability of public finances. According to the debt rule, structural net borrowing[1] of the federal government may not exceed 0.35% of GDP. The provision aims to put a stop to unsound fiscal policy by preventing that government expenditures are increased unduly – beyond sustainable levels – when growth is robust and, as a result, cut excessively – i.e. pro-cyclically and acting as a drag on aggregate demand – when the economy falters. In other words, the objective is to make fiscal policy more stable, reliable and supportive rather than pro-cyclical. It remains to be seen whether this is actually achieved.

Despite the above-mentioned fiscal anchors ("black zero", debt brake), however, fiscal policy on the federal level is turning increasingly pro-cyclical. Apparently, the German government seems prepared to exploit its fiscal scope to the greatest possible extent. In other words, tax payers and contributors will – if at all – benefit only moderately from booming tax revenues (see chart 2) (a major promise of the government to partly revoke the solidarity surcharge for low and middle income earners not before 2021!), (nominal) debt will not be reduced at

[1] Under the debt rule, structural net borrowing is limited to a maximum of 0.35% of GDP generated in the year before the budget is prepared.

all, and a very small portion will go towards "investment" expenditure (that is conducive to production potential such as transport, digitisation, education), whereas public social transfers, which are already at high levels, will be boosted further (including children's allowance for parents who buy or build a home, pensions for mothers II). This approach (to social and pensions policy) is hardly sustainable – at least from a long-term perspective and in view of the burdens resulting from ageing in the middle of the coming decade. The government's move to increase social transfers continues to be problematic insofar as (public and non-insurance) social benefits are rarely raised in line with the principle of need but across the board – at the expense of current taxpayers and contributors as well as future generations. On the spending side, structural pressure is therefore mounting. If implemented, these measures can hardly be revoked.

Budget 2018, budgetary draft 2019 and financial plan until 2022 in the context of the debt brake 5

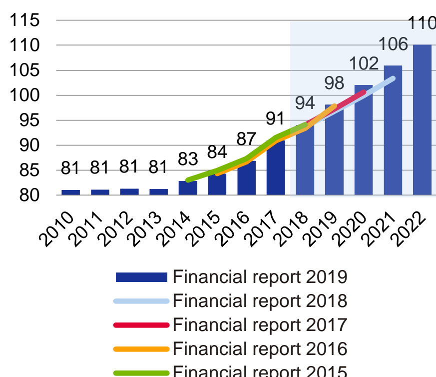
EUR bn	Actual 2017	Target 2018	Draft 2019	Financial plan 2020	2021	2022
Expenditures	**325.4**	**343.6**	**356.8**	**363.2**	**367.3**	**373.5**
% yoy	4.8	5.6	3.8	1.8	1.1	1.7
of which: Investment expenditures (2018: incl. allocated reserves to the fund "digital infrastructure)	34.0	39.8	37.9	37.9	37.9	37.9
% yoy	2.4	17.1	-4.8	0.0	0.0	0.0
% of expenditures	10.4	11.6	10.6	10.4	10.3	10.1
of which: Global over-/underspending		-0.7	1.7	1.3	0.3	0.6
% of expenditures		-0.2	0.5	0.4	0.1	0.2
Revenues	**330.4**	**341.7**	**351.5**	**356.6**	**358.7**	**374.5**
% yoy	4.3	3.4	2.9	1.5	0.6	4.4
of which: Tax revenues	309.4	321.3	333.0	333.8	346.8	359.7
% yoy	7.1	3.9	3.6	0.2	3.9	3.7
% revenues	93.6	94.0	94.7	93.6	96.7	96.0
of which: Global excess revenues / revenue shortfall		-1.5	-7.0	-6.5	-17.6	-14.8
% revenues		-0.4	-2.0	-1.8	-4.9	-3.9
Budget balance (excluding extra budgetary units of the federal government)*	**5.0**	**-1.9**	**-5.3**	**-6.6**	**-8.6**	**1.0**
Budget balance (including extra budgetary units of the federal government)	3.6	-1.0	-8.2	-7.6	-8.8	1.0
Balance of reserves (flows): (-) Payments / (+) Withdrawels	**-5.3**	**1.6**	**5.0**	**6.3**	**8.3**	**-1.3**
Net borrowing (-) / net debt retirement (+)	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Cyclical component	**2.1**	**4.2**	**6.4**	**4.0**	**1.5**	**0.0**
Balance of financial transactions	**-0.8**	**0.3**	**1.0**	**0.8**	**0.7**	**0.9**
Balance of relevant extra budgetary units of the federal government	**-1.4**	**0.9**	**-2.9**	**-1.0**	**-0.2**	**0.0**
Energy and climate fund (Energie- und Klimafonds)	-0.2	0.0	-0.4	-1.0	-0.2	0.0
Reconstruction aid fund (Aufbauhilfefonds)	-0.7	-0.4	-0.7			
Municipal investment promotion fund (Kommunalinvestitionsförderungsfonds)	-0.5	-1.1	-1.8			
Digitalisation fund (Digitalisierungsfond)		2.4				
Structural net borrowing (-) / net debt retirement (+)	**-2.7**	**-3.6**	**-10.3**	**-5.8**	**-2.4**	**-0.9**
Maximum structural net borrowing (upper limit)	**-10.6**	**-11.4**	**-11.4**	**-11.9**	**-12.4**	**-12.8**
Structural budget balance	**2.3**	**-5.5**	**-15.6**	**-12.4**	**-11.0**	**0.1**

* Revenues minus expenditures.

Sources: Federal Ministry of Finance, Deutsche Bundesbank, Deutsche Bank Research

Pension-related spending of the federal government is set to rise strongly over the planning horizon 6

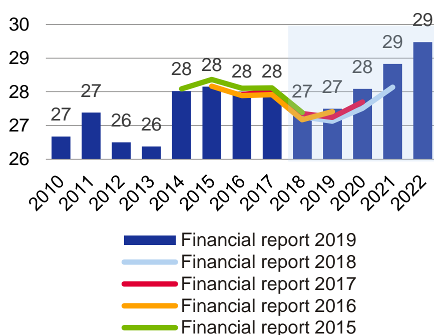
Federal subsidy to the statutory pension insurance system, EUR bn



Sources: Federal Ministry of Finance, Deutsche Bank Research

Share of pension-related spending in total federal government spending is set to become larger and larger 7

Federal subsidy to the statutory pension insurance system, % of total spending



Sources: Federal Ministry of Finance, Deutsche Bank Research

In itself, the extended pension for mothers (through pension entitlements for child-rearing periods which are not covered by social security contributions of the recipient) is likely to swallow up around EUR 3.5 bn per year from 2019 onwards – at the expense of contributors and pensioners. This is equivalent to just under 1% of total federal spending in 2019. Moreover, the children's allowance granted to parents from early 2018 to year-end 2020 to make the construction or purchase of a home more affordable for large sections of the population is estimated at an accumulated EUR 2.7 bn (original expectations of the coalition partners: EUR 2.0 bn) in this legislative period alone (2018-21). When the programme ends in 2029, total costs may come to roughly EUR 10 bn[2]. The balance of probabilities suggests that the allowance will be a costly subsidy of disputable value, which will put further upward pressure on already-elevated house prices – as it is, for instance, also granted to a family of four which hardly qualifies as needy with total taxable income of up to EUR 105,000.

As the share of old-age pension benefits (namely, federal government transfer payments) will rise incrementally owing to these additional social goodies (in particular for pensions) – and the tax boom will not go on eternally – the fiscal scope for other future-oriented spending (on, for example, education, research and infrastructure), tax cuts or debt redemption is de facto limited. Even though the federal government will also set aside more money for investment in the years ahead (with a special focus on replacement investment in transport infrastructure and digital infrastructure development, e.g. in the broadband segment), investment spending of EUR 39.8 bn earmarked for 2018 (investment plus EUR 2.4 bn in federal allocations to the special digital infrastructure fund) is still fairly modest. Whilst nominal amounts over the entire planning period by far exceed actual values in 2017 (EUR 34 bn), their share in total expenditures rises only temporarily (to 11.6% in 2018, up from 10.4% in 2017) and subsequently declines to 10.1% by 2022 (end of fiscal plan). (Note: The children's allowance for parents who buy or build a home is also classified as investment). By comparison: In the same period, federal government transfer payments to the pension scheme (the largest portion of social expenditure) will edge up from 27.9% (2017) to 29.5% (2022). Apparently, the government aims to largely divert current fiscal scope to social spending. According to the 2019 draft budget, spending on social benefits will amount to a hefty EUR 178.2 bn or around half of total federal expenditures. As a glance at Fig. 4 shows, fiscal scope on the spending side stemming from low interest rates is largely used for the expansion of the welfare state. Noticeable tax reductions that go beyond sporadic cosmetic changes (allowances for cold progression, increase in child benefits and the tax-exempt amount for children) are shelved until later. It should be noted in this context that the phase-out of the solidarity surcharge will not start before 2021 (the final year of the legislative period) with an initial step of EUR 10 bn. Moreover, the sound financial situation of the social security system is not fully used to lower contribution rates as required (the increase in non-insurance benefits in the statutory pension scheme has, in fact, eaten up the existing scope for (more) noticeable cuts in contribution rates)[3].

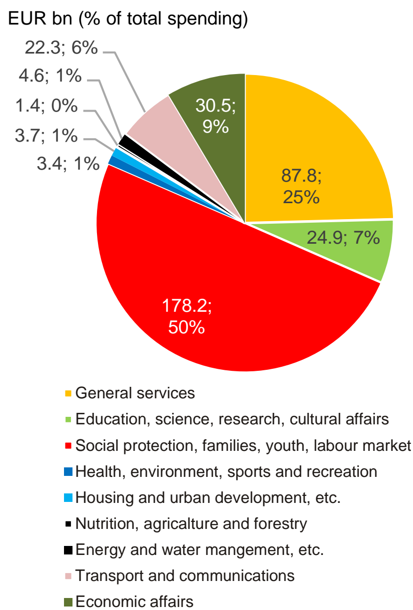
---

[2] Parents whose taxable income does not exceed EUR 75,000 per year on the date of application, plus EUR 15,000 for each child under the age of 18 living in the same household, are entitled to an allowance for the purchase of their first owner-occupied home (existing or new homes). For each child, the government will pay EUR 1,200 annually over a period of ten years.

[3] Whilst the contribution rate for the unemployment insurance will be lowered by 0.5 percentage points in 2019, down from currently 3.0% to 2.5%, the contribution rate for the deficit-ridden social long-term care insurance will, at the same time, be raised by 0.5 percentage points. Relative to 2017, contributors will hence benefit from only marginal cuts, which are owed to the reduction in the contribution rate for the statutory pension system (by 0.1 percentage points to 18.6% from 18.7%) and a negligible decline in the average supplemental premium charged by the statutory health insurance [from 1.1% to 1.0%] (both reductions took effect in early 2018). With the revival of equal health insurance contributions in early 2019 (currently the supplemental premium is exclusively shouldered by wage earners), the burden on employees is eased. As employers have to foot the bill, however, the burden on the factor of labour will be unchanged from today.

Budgetary draft 2019 grouped by spending items 8

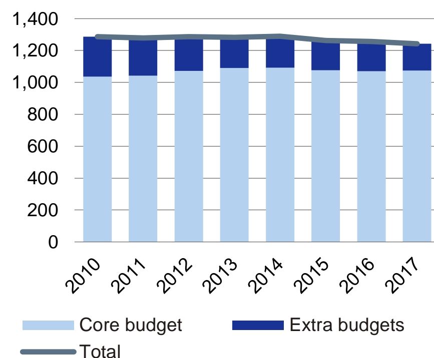
EUR bn (% of total spending)



Sources: Federal Ministry of Finance, Deutsche Bank Research

Federal government debt stock 10

EUR bn (financial statistics)



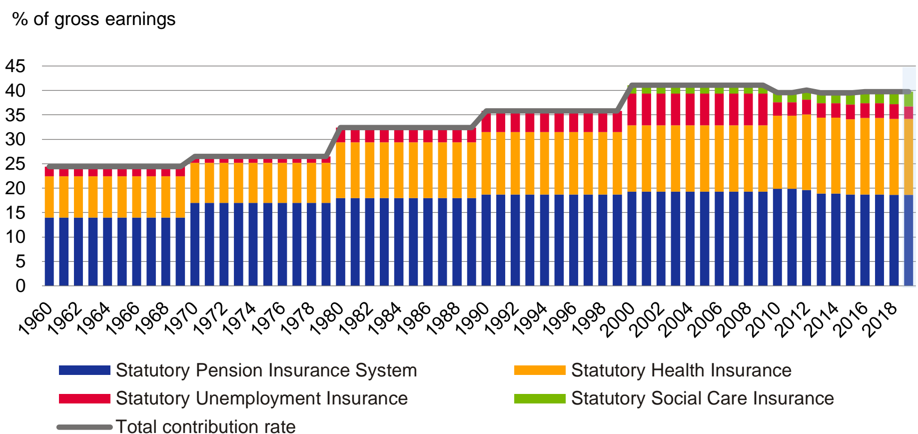
Sources: Federal Ministry of Finance,Deutsche Bank Research

Whilst the debt brake puts a cap on federal net borrowing, it cannot prevent a pro-cyclical shift in fiscal policy

Fiscal scope exists and could widen even further, if tax revenues continue to surprise to the upside. According to the fiscal plan of the government (on the basis of macroeconomic forecasts and the tax estimate of spring 2018), annual federal government revenues in the planning period are expected to rise sharply from EUR 330.4 bn (actual value) in 2017 to EUR 374.5 bn (target value) in 2022 (up by 13.3% or a cumulated EUR 72 bn). The key driver of strong federal revenue growth is dynamic tax intake, which is estimated to surge to EUR 359.7 bn (target value) in 2022, up from EUR 309.4 bn (actual value) in 2017 (up by 16.3% or a cumulated EUR 87.7 bn). In the following, we take a closer look at the 2018-22 period and how much fiscal scope the federal government actually has in the context of the debt brake.

Contributions rates to social security funds 9

% of gross earnings

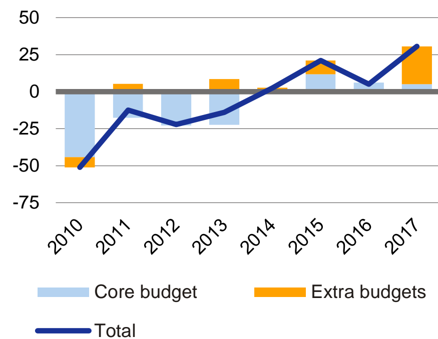


Sources: Deutsche Rentenversicherung (German Statutory Pension Insurance Scheme), Deutsche Bank Research

The fiscal plan foresees a "black zero" for the entire period, which means that the federal government aims to keep net borrowing at zero. The addition of new debt is hence excluded. But this is a far call from reducing debt on the federal level. Only the debt-to-GDP ratio declines courtesy of economic growth, whereas nominal debt remains unchanged (at still-elevated levels). According to the fiscal plan, both the core and the federal budget including the government-operated special funds (off-budget entities) will be in the red throughout the 2018-2021 period. A slightly positive financial result is not targeted before 2022 – i.e. in the next legislative period (see table). The objective of adding no new debt despite rising deficits will primarily be achieved by reducing the reserves that were built up in the preceding years.

Budgetary developments for the federal government 11

Budget balance (financial statistics), EUR bn



Sources: Federal Ministry of Finance, Deutsche Bank Research

In particular, the reserve fund for "asylum seekers and refugees" (short: asylum reserve), which amounted to just under EUR 24 bn at year-end 2017, will be fully used to cover fiscal deficits in the planning period. Set up by the federal government in 2015, this reserve provides the necessary funds for refugee-related costs incurred during the crisis and in future, thereby making provisions for these expenditures in the budget. Although the creation of the reserve appeared prudent at that time, the parked funds have as yet not been withdrawn for the originally intended purpose. Against this backdrop, it would have been logical to dissolve the fund and use it for debt repayments, for instance. Instead, the reserve was topped up further over the past years, up from its initial level of EUR 12.1 bn in 2015 to EUR 23.9 bn at year-end 2017.

Structural net borrowing of the federal government is equivalent to the sum of core budget net borrowing (of zero: "black zero") and the balance of the relevant off-budget entities (such as the climate fund or the fund to promote investment of local authorities); see table "2018-22 fiscal plan of the federal government in the context of the debt brake"), adjusted by a cyclical component[4] and the balance of financial transactions[5].

Derivation of the structural net borrowing of the federal government 12

EUR bn	Actual 2017	Target 2018	Draft 2019	Financial plan 2020	2021	2022
Budget balance of the federal government (core budget)	**5.0**	**-1.9**	**-5.3**	**-6.6**	**-8.6**	**1.0**
+ Balance of relevant extra budgetary units of the federal government	-1.4	0.9	-2.9	-1.0	-0.2	0.0
= Finanzierungssaldo des Bundes (einschließlich relevanter Extrahaushalte)	**3.6**	**-1.0**	**-8.2**	**-7.6**	**-8.8**	**1.0**
- Cyclical component	2.1	4.2	6.4	4.0	1.5	0.0
- Balance of financial transactions	-0.8	0.3	1.0	0.8	0.7	0.9
= Structural budget balance	**2.3**	**-5.5**	**-15.6**	**-12.4**	**-11.0**	**0.1**
Net borrowing (-) / net debt retirement (+) of the federal gov't (core budget)	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
+ Balance of relevant extra budgetary units of the federal government	-1.4	0.9	-2.9	-1.0	-0.2	0.0
- Cyclical component	2.1	4.2	6.4	4.0	1.5	0.0
- Balance of financial transactions	-0.8	0.3	1.0	0.8	0.7	0.9
= Structural net borrowing (-) / net debt retirement (+)	**-2.7**	**-3.6**	**-10.3**	**-5.8**	**-2.4**	**-0.9**
Maximum permissable structural net borrowing according to the debt brake (upper limit)	**-10.6**	**-11.4**	**-11.4**	**-11.9**	**-12.4**	**-12.8**
Maximum structural net borrowing (upper limit), % of GDP	0.35	0.35	0.35	0.35	0.35	0.35
Nominal GDP of the preceding year of budgeting	3,032.8	3,263.4	3,263.4	3,401.7	3,539.4	3,655.4
Saftey margin to maximum permissable structural net borrowing	**7.9**	**7.8**	**1.1**	**6.1**	**10.0**	**11.9**
Maximum permissable net borrowing according to the debt brake	**-9.3**	**-6.9**	**-4.0**	**-7.1**	**-10.2**	**-11.9**

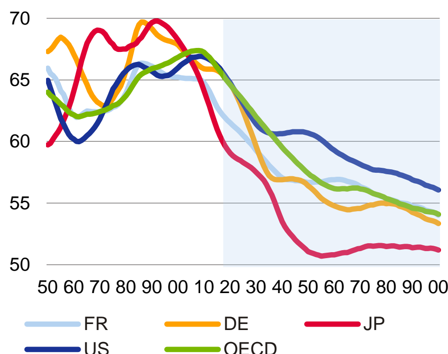
Sources: Federal Ministry of Finance, Deutsche Bundesbank, Deutsche Bank Research

[4] In periods of over-utilisation (with a positive output gap), the cyclical component limits the borrowing scope of the federal government; in periods of under-utilisation (with a negative output gap) it has a mitigating effect.

[5] The balance of financial transactions also includes one-off revenues such as privatisation proceeds, which, however, do not generate additional net borrowing scope for the federal government.

Population projections by the United Nations (medium variant) 13

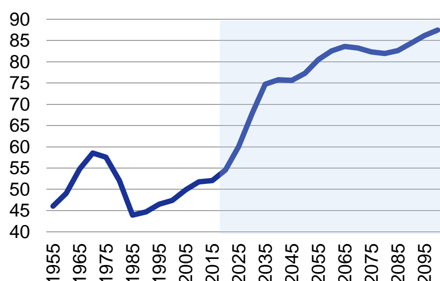
Working-age population, % total population



Sources: United Nations, Deutsche Bank Research

Germany: Total dependency ratio 14

Population aged 0-14 and 65+, % of population aged 15-64



From 2020: Medium variant
Source: United Nations

Structural net borrowing is also negative in the entire period covered by the fiscal plan of the federal government. Whilst the safety margin in relation to the upper limit (EUR 11.4 bn) still comes to EUR 7.8 bn in the current fiscal year, it will shrink to only EUR 1.1 bn in fiscal year 2019 (see table). Given an actual maximum permissible amount of net borrowing under the debt brake of around EUR 6.9 bn and EUR 4.0 bn in fiscal years 2018 and 2019, the scope for new debt is relatively limited, albeit dispensable in view of the federal target of a "black zero". As it can be noted that fiscal scope is already more or less exhausted, additional spending or lowering revenues (e.g. tax relief) in excess of the fiscal plan of the federal government is only feasible in the event of positive surprises during the budget implementation phase (if, for instance, tax revenues are above or spending below plan, e.g. interest payments). As mentioned earlier and taking into account the visible deterioration of the projected structural fiscal deficit (from EUR 5.5 bn in 2018 to EUR 15.6 bn in 2019), the increasingly pro-cyclical approach of the federal government is cause for concern from the perspective of stability policy. The tax boom and ultra-low interest rates will not go on eternally, and the demographic challenge in Germany will put a large(r) burden on public finances from the middle of the next decade, at the latest. Against this backdrop, in particular, plans to upgrade pension benefits are, in fact, counterproductive for the long-term sustainability of public finances. According to estimates of experts, the key promise of the government, the "double stop line"[6], will not yet weigh considerably on the federal budget – at least in the current legislative period. But starting in 2025 (when the current pension programme of the government expires), considerable adjustments may be required (e.g. withdrawal of current promises, rapid rise in federal transfer payments and/or an increase in retirement age).

Use of reserves, off-budget entities and global provisions leads to a lack of clarity and covers up the structural deterioration of the budget

Alongside the federal core budget, the German government currently uses several special instruments, including the accumulation (and the future depletion of financial reserves resp. reserve funds such as the asylum fund or the "demographic fund"[7] that will be set up beginning in 2021), the creation of off-budget entities (as, for example, the energy and climate fund or the digital infrastructure fund[8]) and the use of global provisions on the revenue and expenditure side when drafting the budget and the fiscal plan.

In its Monthly Report of August 2018[9], the German Bundesbank highlights the specific pros and cons of reserve funds - and off-budget entities excluded from the debt brake. As a precaution against cuts on the spending side, a key argument in favour of using (financial) reserves is that they can be set up in good times to eventually stabilise fiscal policy when growth falters, thereby serving as a safeguard against pro-cyclical fiscal policy in crisis periods. Moreover, financial reserves can be used to smooth larger spending programmes, the timing of which is hard to estimate (e.g. defence investments).

---

[6] The "double stop line" ensures that the contribution rate for the statutory pension system does not exceed 20% until 2025, whilst the replacement rate (the relation between the pension entitlement of an average earner after 45 years of contribution and average wages) is, at least, stabilised at the current level of 48%.

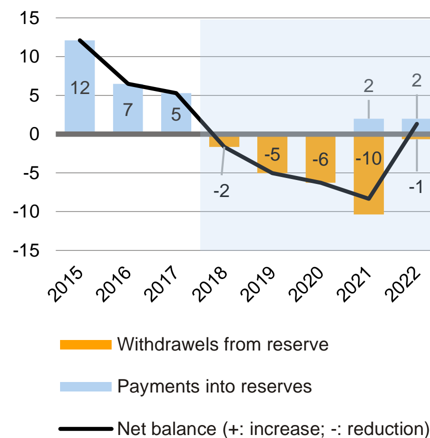
[7] To safeguard the maximum contribution rate against unforeseen events, the fiscal plan earmarks, starting in 2021, annual funds of EUR 2 bn for the "demographic fund".

[8] In the fiscal year 2018, EUR 2.4 bn are allotted to this fund, which will in future be topped up with proceeds from the sale of licenses for 5G and UMTS networks.

[9] See „Exkurs: Zur Nutzung von Rücklagen und Extrahaushalten bei Bund und Ländern“. Pages 70-74. Monthly Report August 2018. Deutsche Bundesbank.

Balance of reserve items (flows) in the federal budget and fiscal plan 15

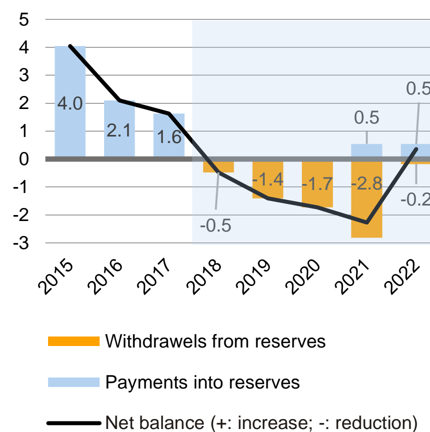
EUR bn



Sources: Federal Ministry of Finance, Deutsche Bank Research

Balance of reserve items (flows) in the federal budget and fiscal plan 16

% of total federal budget spending



Sources: Federal Ministry of Finance, Deutsche Bank Research

Despite their potential value, these benefits stand in contrast to partially serious problems. In particular, clarity and transparency of budget and fiscal plans can be undermined considerably, if individual or numerous special instruments are used simultaneously, as in the case of the federal government's current fiscal plan. Given its complexity, its analysis meanwhile requires ever-increasing expertise. Sometimes, these special instruments are not disclosed in a transparent, clear and complete manner, nor is the budgetary objective they are pursuing substantiated.

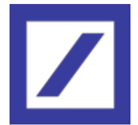
As illustrated by the above asylum reserve, special instruments can also be detrimental insofar as, thanks to the liquidation of financial reserves that were set up in the preceding years and irrespective of the debt rules, the fiscal stance can be loosened markedly when growth is strong (as is currently the case). Fiscal policy, however, is not stabilised. In this event, a key objective of the debt brake – namely, to restrain fiscal policy in times of strong growth – can also be shirked by the government. In particular, it is critical if structural imbalances either arise or are concealed, as reserves are used to cover sustained fiscal deficits. Assuming that excessive spending increases can be funded from reserves in a legislative period, necessary structural adjustments (tax hikes, spending cuts) are shelved until the financial reserves are eventually depleted. In the current planning period, the structural deficit (EUR 2 bn in 2018, EUR 5 bn in 2019, EUR 6 bn in 2020 and EUR 10 bn in 2021) is largely financed by tapping the asylum fund, which serves as the major reserve instrument under the current fiscal plan (see chart "balance of federal reserves movements").

Another budgetary instrument that adds further to the lack of clarity of the federal government's current fiscal plans and that is not explained in detail in many instances, is the use of so-called global provisions. At present, these are employed on the revenue as well as on the spending side. Both additional or reduced revenues or expenditures can, for instance, help to create additional fiscal scope in future[10]. This instrument is frequently used under the current fiscal plan, too. Whilst additional global spending in the planning period will at maximum come to EUR 1.7 bn (2019) and can be regarded as an unused item, global revenue shortfalls are much higher (EUR 7.0 bn in 2019, EUR 6.5 bn in 2020, EUR 17.6 bn in 2021 and EUR 14.8 bn in 2022). These fairly large amounts, which will rise to several per cent of total federal expenditures resp. revenues over the next fiscal years (see charts 17 and 18), can be regarded as extra fiscal funds (if net additional expenditure is positive) or as future, as yet unspecified, need for adjustment (spending cuts or tax hikes, if net additional expenditure is negative).

Conclusion: Higher social transfers weigh on the long-term sustainability of public finances – off-budget entities and reserves conceal the structural deterioration of the federal budget

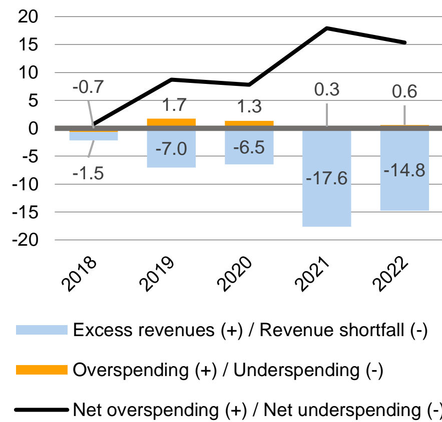
It can be concluded that conditions for the general government budget will likely remain very favourable in the years ahead – provided interest rates do not rise sharply and/or the economy slips into a deep recession. Although fiscal policy is pro-cyclical, the general government surplus may come in above 1% relative to GDP over the next two years and the debt-to-GDP ratio is expected to undershoot the Maastricht threshold of 60% already this year or by 2019, at the very latest. On the face of it, fiscal policy appears to be very solid. But the

[10] If the government earmarked a global underspending position of EUR 1 bn in the budget plan, the federal government has still to cut spending by EUR 1 bn in future, in order to achieve total spending target values. Conversely, global excess expenditures imply that the federal government has funds at its disposal that have not yet been explained in detail. Global revenue shortfalls artificially push revenues below the estimated value and can hence serve as additional fiscal scope once the estimated value is achieved (e.g. tax revenues).



Balance of global budgetary items in the federal budget and fiscal plan 17

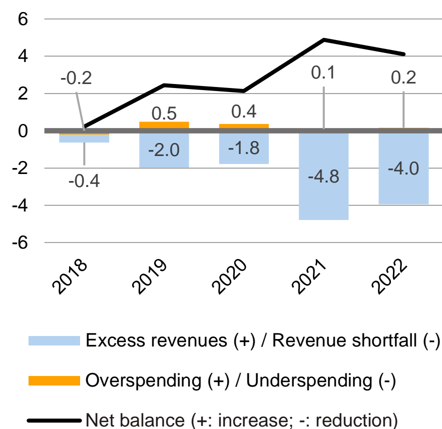
EUR bn



Sources: Federal Ministry of Finance, Deutsche Bank Research

Balance of global budgetary items in the federal budget and fiscal plan 18

% of total federal budget spending



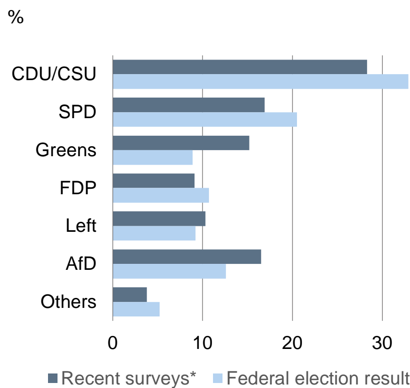
Sources: Federal Ministry of Finance, Deutsche Bank Research

government's structural position (adjusted for positive cyclical effects) is deteriorating, which implies potential risks for the budget should growth falter or interest rates rise. The situation is mitigated insofar as fiscal planning of the federal government seems conservative in other areas (see, for example, the fairly large amounts of global revenue shortfalls). In the face of current particularly favourable fiscal developments, it can also be assumed that the federal government will not – as envisaged in the 2018 budget – run a deficit of EUR 1.9 bn but another surplus, which means that depletion of the asylum reserve might be shelved until later. Although investment (transport, digitisation) is raised markedly in nominal terms (compared with 2017), the increase is only temporary relative to total expenditures and, unlike social transfers, investment continues to be modest. Not much has changed, really. A little bit more of everything, whilst pressing fiscal issues (pensions) are put off into the future (a new legislative period).

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

The view from Berlin

Major political parties' popularity & result of the past federal election 1



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

Source: Wahlrecht.de (October 1)

Is Seehofer doing a good job as Interior Minister? 2

in %

Yes		No
61	AfD supporter	33
31	CDU/CSU supporter	64
27	FDP supporter	69
11	SPD supporter	85
9	Greens supporter	87
8	Left supporter	92

Source: Deutschlandtrend, Infratest dimap, 21. Sept. 2018

Upcoming regional elections will likely create further headwinds for Merkel and the Groko government

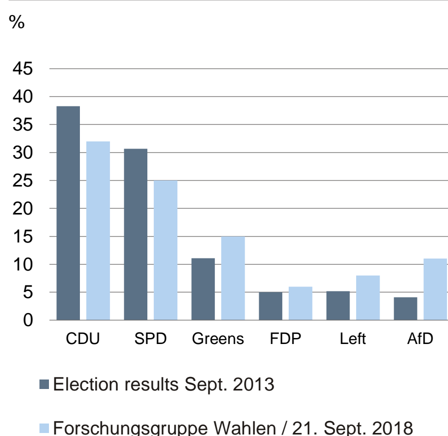
Despite external challenges such as the widening of the US-China trade conflict and its potential implications for German exporters or the hammering out of the Brexit agreement, the governing tri-party coalition in Berlin continues to be tied up with internal crisis management. The shallow settlement of the dispute over the dismissal of Germany's chief of the domestic intelligence service is not only a reflection of the different views on how to handle the contentious issue of migration among the coalition partners, it has also demonstrated the tensions within the coalition: the dismissal of Maaßen was mainly pursued by the SPD, although it was the Chancellor's reputation which was undermined by Maaßen's controversial newspaper interview. The handling of the issues has further increased the dissatisfaction of the CDU/CSU group and SPD fraction with a coalition that takes the government to the brink of collapse largely due to infighting.

This triggered past Tuesday's ousting of Merkel's ally Volker Kauder (holding the position for 13 years) as the whip of the CDU/CSU fraction and the election of his challenger and Kauder's deputy since 2014, Ralph Brinkhaus. Brinkhaus' surprisingly clear success in the secret ballot is a warning to the Chancellor and other party leaders. It is, however, less a signal of a radical opposition to Merkel from her parliamentary group but the desire of the MPs to make a clearer case for a center-right profile in the governing coalition and a stronger role for MPs in designing the policy course, a discomfort dating back to the euro crisis management when "dissidents" were whipped into line. The regained selfconfidence of the CDU/CSU fraction might constrain Merkel's room for striking domestic and European compromises to a certain extent but Brinkhaus – a competent and pragmatic finance expert rooted in the CDU/CSU pro-business wing and campaigning with the promise to act as a bridge-builder between the different camps in the group – is likely to ensure a constructive cooperation with the chancellor. Calls by the opposition for Merkel to face a confidence vote in the parliament after the party turmoil were premature, though, and would in all likelihood yield a positive result anyway given that the surveys for the governing parties do not promise a brighter future for them after snap elections. In recent surveys, on average, the CDU/CSU and the SPD together only got about 45%, i.e. they clearly missed the absolute majority. It is not surprising that meanwhile the Chancellor's spokesman has rejected the opposition parties' request for a confidence vote.

However, the headwinds for Chancellor Merkel but also for her coalition partners will heavily depend on the outcome of the upcoming regional elections. With just about two weeks until polling day of Oct 14, the row over migration is likely to be a major reason for the surveys to promise a shake-up of the political landscape in the state of Bavaria (see chart). The ruling CSU, the smallest partner in Germany's grand coalition, is in crisis mood as polls point towards a loss of the absolute majority – a privilege the CSU has enjoyed since 1966 (except the 2008-2013 term with the FDP). The absolute majority is of major importance for the CSU's selfconception as Bavaria's sole serious political power and for its special influence on the federal level as the CDU's powerful sister party. Satisfaction with the current Bavarian government and PM Markus Söder is declining despite the excellent economic situation of the state which harbours German blue chip companies such as BMW or Siemens. Instead, in Bavaria, a "front-line state" with borders to Austria, concerns over refugees and the respective policy rank high with 44% of Bavarians citing this as the main challenge (infratest dimap: BayernTrend September 2018).

Attempts by the federal interior minister Horst Seehofer (CSU) to sharpen the profile of the CSU and making up ground on the AfD by taking a hard line on migration in Berlin – even at the price of a government crisis – did most likely backfire for his party. Approval ratings have dropped to a historic all-time low of 35% for the CSU (with more than 50% of voters still undecided, though). The blame game is already on and such a poor result would likely trigger a reshuffling of the party's leadership and cabinet posts including that of interior minister Seehofer. Also, the CSU will face difficult coalition negotiations given the diverse political landscape with two parties right from it (AfD and Free Voters) and two to the left (Greens and SPD) with the chances of the FDP and Left to enter the Landtag still open. In arithmetic terms, a two-party coalition would only work with the Greens who seem to have attracted moderate voters away from the CSU.

Approval ratings of parties in Hesse 3

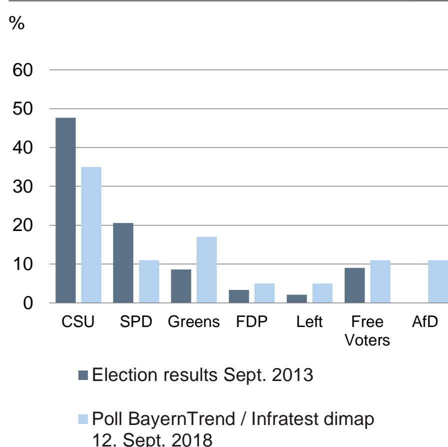


Source: Wahlrecht.de

While most eyes are on the election in Bavaria, there is another important state election ahead. In Hesse, home to Germany's Finanzplatz Frankfurt, elections will take place just two weeks later, on October 28. The CDU-Green coalition – the first in one of the larger and wealthier German states – is widely perceived as working rather smoothly and efficiently. Still, it cannot be sure to retain its majority according to recent polls (ZDF Politbarometer). While the CDU is likely to remain the strongest party allowing PM Volker Bouffier – an important CDU grandee and long-standing supporter of Merkel – to stay on, a significant drop in voter support would most certainly be interpreted as another blow to Merkel's policy and her standing in the party. With the AfD expected to achieve doubledigit results, surveys so far indicate a majority only for a CDU/SPD or possibly a CDU/Green/FDP coalition. The historic strong animosity between CDU and SPD in Hesse speaks against a Groko in this state. Forming a so-called Jamaica coalition of CDU/Green and FDP, an endeavour that failed on the federal level in autumn 2017 but worked in the northern state of Schleswig-Holstein, might be a realistic option in Hesse also.

Bottom line: For the time being state elections' results will not fundamentally endanger Merkel's government but expect continued political headwinds for her government over the next months as (i) the likely weak results for the SPD will spark further internal debates (ii) the likely loss of the CSU majority might trigger a reshuffle of CSU cabinet posts in Berlin (iii) picking the right coalition partners will take some time, in particular in Bavaria, and thus slowdown political decisionmaking (iv) in the likely event of a meagre outcome for the CDU in Hesse in addition to severe CSU losses Chancellor Merkel's power and standing within her party and the general public will erode further and (v) if the CSU will (be forced to) establish a center-left or center-green coalition government in Munich it would be difficult for the CSU to continue acting as veto player on the federal level, e.g. with regard to the asylum policy and European policy issues.

Approval ratings of parties in Bavaria 4



Source: Wahlrecht.de

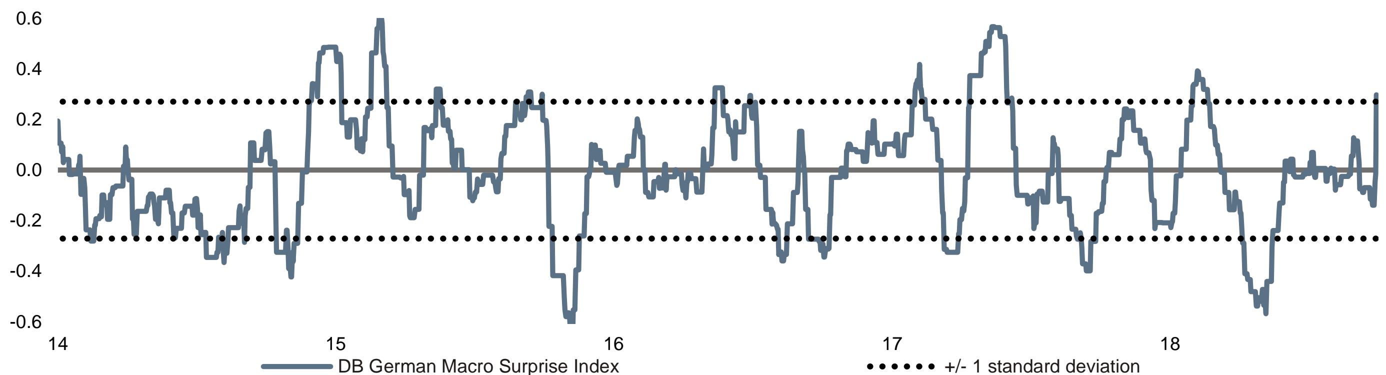
With regard to Merkel's support in her own party and with it the stability of the government, a further major signpost will be the CDU party convention on December 6-8 where Merkel has to stand up for re-election as CDU party leader. Speculations in the media that Merkel could prematurely pass on the party leadership to a successor, were scotched by her last Thursday. Merkel stressed once again that she considers it strategically important to hold the post of chancellor together with that of the CDU party leader. The new party whip Brinkhaus backs Merkel's view. However, it cannot be ruled out that a distinctly weak result let alone a (unlikely) failure of reaching an endorsement by the party members could create a new situation for her.

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

DB German Macro Surprise Index

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

DB German Macro Surprise Index



Sources: Bloomberg Finance LP, Deutsche Bank Research

Last 20 published economic data for Germany

Bloomberg Tickers	Indicator	Reporting month	Publication date	Current value	Bloomberg consensus	Surprise	Standardised surprise	Quantile rank
GRIFPBUS Index	IFO Business Climate	8 2018	27/08/2018	103.9	101.8	2.1	0.0	1.0
GRIMP95Y Index	Import Price Index (% yoy)	7 2018	30/08/2018	5.0	5.2	-0.2	0.2	0.5
GRUECHNG Index	Unemployment Change (000's mom)	8 2018	30/08/2018	-10.0	-8.0	2.0	-0.1	0.4
GRFRIAMM Index	Retail Sales (% mom)	7 2018	31/08/2018	-1.1	-0.2	-0.9	-0.5	0.3
MPMIDEMA Index	Markit Manufacturing PMI	8 2018	03/09/2018	55.9	56.1	-0.2	-0.2	0.3
MPMIDESA Index	Markit Services PMI	8 2018	05/09/2018	55.0	55.2	-0.2	-0.2	0.4
GRIORTMM Index	Factory Orders (% mom)	7 2018	06/09/2018	-0.9	1.8	-2.7	-1.3	0.1
GRCAEU Index	Current Account Balance (EUR bn)	7 2018	07/09/2018	15.3	20.0	-4.7	-1.7	0.0
GRIPIMOM Index	Industrial production (% mom)	7 2018	07/09/2018	-1.1	0.2	-1.3	-1.0	0.1
GRTBALE Index	Trade Balance (EUR bn)	7 2018	07/09/2018	16.5	19.5	-3.0	-1.3	0.1
GRBTIMMM Index	Imports (% mom)	7 2018	07/09/2018	2.8	0.1	2.7	1.1	0.9
GRBTEXMM Index	Exports (% mom)	7 2018	07/09/2018	-0.8	0.3	-1.1	-0.6	0.2
GRZECURR Index	ZEW Survey Current Situation	9 2018	11/09/2018	76.0	72.0	4.0	0.5	0.7
GRZEWI Index	ZEW Survey Expectations	9 2018	11/09/2018	-10.6	-13.0	2.4	0.3	0.7
GRCP20YY Index	CPI (% yoy)	8 2018	13/09/2018	2.0	2.0	0.0	0.2	0.3
MPMIDESA Index	Markit Services PMI	9 2018	21/09/2018	56.5	56.5	0.0	0.0	0.5
MPMIDEMA Index	Markit Manufacturing PMI	9 2018	21/09/2018	53.7	53.7	0.0	0.0	0.5
GRIFPBUS Index	IFO Business Climate	9 2018	24/09/2018	103.7	103.2	0.5	0.0	0.8
GRCP20YY Index	CPI (% yoy)	9 2018	27/09/2018	2.3	2.0	0.3	2.1	1.0
GRUECHNG Index	Unemployment Change (000's mom)	9 2018	28/09/2018	-23.0	-9.0	14.0	0.4	0.7

Sources: Bloomberg Finance LP, Deutsche Bank Research

Updated by Sebastian Becker and Jochen Möbert (+49 69 910-31727, jochen.moebert@db.com)
Source: Heiko Peters (2014). DB German Macro Surprise Index. Focus Germany, 4 August 2014.

Increasing headwinds but fiscal surplus (still) rising

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

Date	Event	Remarks
1 Oct	Eurogroup and ECOFIN meeting, Brussels	Thematic discussion on growth and jobs – national automatic stabilisers; preparation of international meetings including exchange rate developments and of the October European Council.
14 Oct	State election in Bavaria	According to recent surveys the CSU is likely to lose the majority of seats in the Bavarian parliament. The formation of a new state government might prove to be very difficult. The Greens or the SPD could become coalition partners.
18 Oct	European Council meeting, Brussels	The meeting will focus on EU asylum policy issues, esp. management of the external borders and support for countries of origin and transit countries, and the state of the Brexit negotiations. The latter could also be subject of a possible special summit in November.
25 Oct	ECB Governing Council meeting, press conference	The ECB is right to set the monetary policy stance to offset potential downside risks to growth. We expect there will be sufficient trust in the outlook for inflation for the ECB to follow through on its decision to phase out QE in Q4. We expect a 20bp deposit rate hike and simultaneous 25bp refi hike in Sep 2019 followed by the same again in March 2020.
28 Oct	State election in Hesse	Recent surveys indicate that the present coalition among the CDU and the Greens will lose its majority. From the present point of view a Jamaica coalition among the CDU, the Greens and the FDP or a grand coalition seems possible. If the CDU as well as the CSU will perform poorly, growing unrest in both parties is likely, which could further weaken Chancellor Merkel's position as CDU leader.
5 Nov	Eurogroup and ECOFIN meeting, Brussels	Thematic discussion on growth and jobs – financial stability in the EMU; Banking Union – euro area aspects, (poss.) Debrief of the G7 meeting; (poss.) Greece – post programme framework.
3-4 Dec	Eurogroup and ECOFIN meeting, Brussels	Assessment of euro area Member States' Draft Budgetary Plans and of the euro area budgetary situation and prospects, (poss.) Implications of the Commission services' autumn 2018 forecast for fiscal surveillance; implementation of the Stability and Growth Pact, Excessive Deficit Procedures for euro area countries, Eurogroup Work Programme H1 2019, among others.
6-8 Dec	CDU party convention, Hamburg	Public attention will focus on the party leadership elections. Chancellor Merkel will stand up again for partyleader. In the past election in December 2016 89.5% of the delegates voted for her. Only in 2004 her result was worse (88.4%, best result 2012: 97.9%).

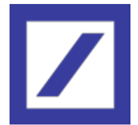
Source: Deutsche Bank Research

Germany: Data calendar

Date	Time	Data	Reporting period	DB forecast	Last value
5 Oct 2018	8:00	New orders manufacturing (% mom, sa)	August	1.0	-0.9
8 Oct 2018	8:00	Industrial production (% mom, sa)	August	1.2	-1.9
9 Oct 2018	8:00	Trade balance (EUR bn, sa)	August	17.6	15.8
9 Oct 2018	8:00	Merchandise exports (% mom, sa)	August	0.2	-0.8
9 Oct 2018	8:00	Merchandise imports (% mom, sa)	August	-1.6	2.8
24 Oct 2018	9:30	Manufacturing PMI (Flash)	October	54.8	53.7
24 Oct 2018	9:30	Services PMI (Flash)	October	57.0	56.5
25 Oct 2018	10:00	ifo business climate (Index, sa)	October	104.0	103.7
30 Oct 2018	9:55	Unemployment rate (%, sa)	October	5.1	5.1
30 Oct 2018	14:00	Consumer prices preliminary (% yoy, nsa)	October	2.2	2.3
31 Oct 2018	8:00	Retail sales (% mom, sa)*	September	0.5	-0.1

*An earlier data release may be possible due to the Federal Statistical Office.
Sources: Deutsche Bank Research, Federal Statistical Office, Federal Employment Agency, ifo, Markit

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



Financial Forecasts

	US	JP	EMU	GB	CH	SE	DK	NO	PL	HU	CZ
Key interest rate, %											
Current	2.125	-0.10	0.00	0.75	-0.75	-0.50	0.05	0.75	1.50	0.17	1.50
Dec 18	2.375	-0.10	0.00	0.75	-0.75	-0.50	0.05	0.50	1.50	0.30	1.50
Mar 19	2.625	-0.10	0.00	0.75	-0.75	-0.25	0.05	0.75	1.50	0.50	1.50
Jun 19	2.875	-0.10	0.00	0.75					1.50	0.85	1.75
3M interest rates, %											
Current	2.40	0.05	-0.32	0.80							
Dec 18	2.73	0.05	-0.30	0.80							
Mar 19	2.93	0.05	-0.30	0.80							
Jun 19	3.18	0.05	-0.30	0.80							
10Y government bonds yields, %											
Current	3.07	0.13	0.47	1.52							
Dec 18	3.50	0.10	0.90	1.70							
Mar 19	3.60	0.10	0.95	1.75							
Jun 19	3.60	0.10	1.00	1.75							
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	1.16	113.47	0.89	1.30	1.13	10.25	7.46	9.47	4.25	324.37	25.72
Dec 18	1.17	108.00	0.85	1.38	1.12	10.70		9.40	4.30	325.00	25.40
Mar 19	1.21	105.50	0.86	1.41	1.14	10.50		9.30	4.33	330.00	25.20
Jun 19	1.25	103.00	0.87	1.44	1.15	10.30		9.20	4.35	335.00	25.00

Sources: Bloomberg Finance LP, Deutsche Bank Research

Increasing headwinds but fiscal surplus (still) rising

German data monitor

	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Apr 2018	May 2018	Jun 2018	Jul 2018	Aug 2018	Sep 2018
Business surveys and output											
Aggregate											
Ifo business climate	103.8	105.1	104.3	102.3	103.1	102.5	102.4	102.0	101.7	103.9	103.7
Ifo business expectations	102.0	103.0	100.7	98.6	100.1	98.7	98.6	98.6	98.1	101.3	101.0
Industry											
Ifo manufacturing	107.8	109.0	108.0	104.9	104.5	105.0	104.9	104.8	104.1	104.9	104.5
Headline IP (% pop)	1.7	0.9	0.1	0.3		-1.5	2.5	-0.7	-1.9		
Orders (% pop)	2.1	3.4	-2.2	-1.6		-1.5	2.6	-3.9	-0.9		
Capacity Utilisation	86.9	87.7	88.2	87.8	87.8						
Construction											
Output (% pop)	-0.4	-1.0									
Orders (% pop)	-1.7	10.3	-1.6	-4.0		2.3	4.2	-4.1	1.9		
Ifo construction	109.8	110.6	110.2	111.6	116.5	111.5	111.9	111.4	115.4	116.5	117.7
Consumer demand											
EC consumer survey	4.1	5.5	6.7	5.5	4.5	6.1	5.9	4.6	4.5	4.4	4.5
Retail sales (% pop)	0.1	0.5	-0.3	1.5		2.0	-1.4	1.1	-1.1	-0.1	
New car reg. (% yoy)	0.3	4.2	4.0	1.9		8.0	-5.8	4.2	12.3	24.7	
Foreign sector											
Foreign orders (% pop)	3.5	4.9									
Exports (% pop)	0.7	2.5	-0.2	1.1		-0.2	1.7	0.1	-0.8		
Imports (% pop)	0.2	2.8	0.0	2.6		2.1	1.1	1.3	2.8		
Net trade (sa EUR bn)	62.4	63.2	62.5	59.3		19.6	20.4	19.3	15.8		
Labour market											
Unemployment rate (%)	5.7	5.5	5.4	5.2	5.2	5.3	5.2	5.2	5.2	5.2	5.1
Change in unemployment (k)	-28.7	-52.0	-68.0	-41.0	-35.3	-9.0	-12.0	-15.0	-7.0	-10.0	-23.0
Employment (% yoy)	1.4	1.3	1.4	1.3		1.4	1.3	1.3	1.3	1.3	1.3
Ifo employment barometer	103.3	104.0	104.7	103.8	104.7	103.3	104.2	104.0	104.1	105.1	104.8
Prices, wages and costs											
Prices											
Harmonised CPI (% yoy)	1.7	1.6	1.4	1.9	2.1	1.4	2.2	2.1	2.1	1.9	2.2
Core HICP (% yoy)	1.5	1.3	1.3	1.2	1.2	1.0	1.5	1.1	1.2	1.1	1.2
Harmonised PPI (% yoy)	2.7	2.5	2.0	2.6		2.0	2.7	3.0	3.0		
Commodities, ex. Energy (% yoy)	4.2	-5.6	-12.4	2.6		-6.3	5.9	9.2	0.9	-0.2	
Crude oil, Brent (USD/bbl)	52.2	61.5	66.9	74.5		72.0	76.9	74.4	74.3	72.5	78.8
Inflation expectations											
EC household survey	16.3	16.0	16.4	17.3	21.4	15.1	16.8	19.9	20.7	21.9	21.5
EC industrial survey	10.2	14.2	15.0	13.8	15.8	14.6	12.1	14.6	15.1	15.9	16.5
Unit labour cost (% yoy)											
Unit labour cost	1.7	1.2	2.5	1.8							
Compensation	2.6	2.5	2.8	3.0							
Hourly labour costs	2.5	2.6	3.5	1.4							
Money (% yoy)											
M3	4.7	4.3	3.3	3.6		3.5	4.2	3.6	3.8	3.5	
M3 trend (3m cma)						3.3	3.7	3.8	3.9		
Credit - private	3.9	4.2	4.3	4.3		4.3	4.1	4.3	4.2		
Credit - public	5.5	-2.9	-20.0	-7.0		-8.7	-8.8	-7.0	-5.8		

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