Bundesverband der Deutschen Industrie e.V.

QUARTERLY REPORT GERMANY

Turbulence imperils robust recovery.

German economy in choppy waters

Quarter I / 2016

- **Turbulent financial and commodity markets and security issues threaten to throw a strengthening world economy off track.** With 2015 having been the weakest post-crisis year, we now expect the growth rate to rise slightly to around 3.25 to 3.5 percent.
- **The United States, Europe and Japan will likely continue their moderate recovery, but China will see further slowing.** Growth rates for emerging market countries and for most of the advanced industrialised countries will probably increase slightly. Brazil and Russia should be in for another year of declining economic output.
- **The German economy will be primarily driven by domestic factors in 2016.** The main domestic driver is private consumption, which is supported by ongoing labour market improvement and low inflation. The public sector is expected to spur demand as well. But low interest rates and stronger corporate balance sheets alone are insufficient to properly boost investment, particularly given the unsettling current geopolitical situation and China's ailing stock markets. This year's GDP is projected to grow at an annualised rate of 1.9 percent, provided that global economic conditions remain more or less in line with forecasts.

Content

World economy picking up after a slow year

The year 2016 started out much like the summer of 2015 ended: with the world in economic turmoil. Early in the year Chinese stock market indices experienced a significant drop, and in the past few months China's currency fell steadily against the US dollar. The markets are still in the dark about the direction of the country's monetary policy. Financial market anxiety over Chinese economic policy has greatly intensified even though the country hit its growth target almost exactly, as we had forecast (see Deutsch and Müller 2015 for a detailed analysis of China). The markets are unsure whether and to what extent interest rates will be rising further in the United States in view of sharp corrections in share prices, the rising external value of the dollar and the presumably continuing modest outlook for inflation. Instead of the four interest rate moves that the Fed had signalled in December, the financial markets are now only pricing in one or two. Oil prices have fallen again sharply in connection with the escalating Saudi Arabia-Iran conflict. Iran resumed selling oil when sanctions were lifted in mid-January, further increasing the global oversupply. The markets, however, are expecting oil prices to climb back over the course of the year.

Global growth lower in 2015

Preliminary calculations indicate only around 3 percent expansion of the global economy in 2015, which is the weakest rate since 2010 and half or even a full percentage point below the level forecast by international organisations a year ago (IMF 2016, 2015; OECD 2015).

Global trade growth was far below normal rates and ranges, and trade volumes are estimate to have only increased slightly (IMF: up 2.6 percent; OECD: up 2 percent). Chinese import volume declined as a result of the structural shift to services; weaker exports due to a significantly stronger renminbi, resulting in lower imports of industrial goods; as well as the increasing substitution of domestic products for imported intermediate goods. In addition, recession-related factors drove imports down 10 percent in Brazil and 20 percent in Russia. Commodity exporters suffered as well from the major fall in Chinese demand (OECD 2015).

Global industrial production is believed to have risen less than 2 percent, with much of that growth coming from emerging market countries (January to September 2015: up 2.5 percent from the previous year's average; industrialised countries saw a good 0.5 percent increase). Chinese industrial production growth declined for the fifth consecutive year, to 5 percent, while in the United States, Japan, South Korea and Europe production levelled off or increased only marginally (Hüne 2015).

International direct investment, however, surged to 1.7 trillion US dollars (up 36 percent over last year's weak figure) on strong inflows into the European Union and United States. Industrialised countries accounted for 55 percent of inflows, which were principally connected with mergers and acquisitions, as there were hardly any new projects. Commodity-producing countries experienced significant declines. Investment in China and Hong Kong continued to increase. China mainly attracted capital for its service industries, while direct investment in the manufacturing sector declined (UNCTAD 2016).

There were substantial regional differences within the global economy, as Europe and the United States showed robust growth while Asia softened. However, the US economy still fell well short of the real growth rate of 3 to 3.5 percent forecast at the start of 2015. It grew around 2.25 percent in the first three quarters (see BDI 2015), with the IMF forecasting 2.5 percent for the full year, and the OECD 2.4 percent. Private consumption, services, construction spending and the labour market fuelled expansion, while the manufacturing sector and foreign trade had only a muted effect due to currency appreciation. Economic output for OECD countries is estimated to have risen 2 percent. Private consumption has been a driver for nearly all countries, while investment and foreign trade (net exports) have barely contributed to output. Non-OECD countries are estimated to have grown by less than 4 percent (OECD: 3.7 percent), a full half point lower than the year before, due almost exclusively to severe recessions in Brazil and Russia. China recorded 6.9 percent growth thanks to a dynamic service sector led by e-commerce and payment services (Huang and Lardy 2016), but industrial production slowed further and the property market continued to correct, having a substantial dampening effect on economies throughout much of Asia. India showed further dynamic growth, while it was a relatively weak year for Japan. Europe’s recovery gained traction, with euro area economies growing at around 1.5 percent (2014: 0.8 percent).

Inflation came in lower than expected. The extraordinary effects of an oil oversupply, declining commodity prices, a Chinese slowdown and continuing output gaps in many economies caused global inflation to fall to nearly zero. Wage-price dynamics normally seen in a recovery have not materialised, even in countries with very low unemployment like Japan, the United States and Germany. The US Federal Reserve reversed its monetary policy stance with an initial interest rate rise in December, announcing further moves would be forthcoming this year. The central bank balance sheet is expected to remain stable. The considerable 20 percent increase in the US dollar on a real and trade-weighted basis since last summer also played a role in keeping economic activity and inflationary pressures at their current very moderate levels. The Fed will, however, likely be raising rates somewhat more quickly than the markets are presently pricing in. In addition, rising bond yields should result in substantial portfolio rebalancing, supporting the view that the dollar could appreciate further.

In contrast, the European Central Bank and the central banks of China, Japan and many other countries adopted a more expansionary monetary policy last year to stimulate inflation and economic activity. Falling commodity prices (down 30 percent since summer 2015) and the cooling off of the Chinese economy have kept deflationary pressure in place, which will likely prompt central banks to take further monetary policy measures in order to reach their targets. Inflation should pick up somewhat in the second half of the year once the gradual oil price recovery gets under way. Commodity prices – which have plummeted 30 percent since last summer – have yet to find a bottom. Further depreciation of the renminbi against the US dollar, with much greater stability relative to the new basket, would not be a surprise, nor would a further decline in the euro versus the dollar. The fiscal policy stance is still fairly neutral on the whole, as governments are gently going about reducing budget deficits.

Global economic growth could accelerate slightly in 2016

International organisations project the global economy to grow by at least a quarter of a point in 2016. Global trade is also projected to increase to around 3.5 percent (OECD: 3.6 percent, IMF: 3.4 percent). However, the deterioration in the medium-term growth outlook over the last two years is no insignificant matter. There are also considerable financial risks, particularly for certain emerging market countries and private enterprises with high levels of dollar debt in those countries.

International organisations are confident that the US economy will see real growth of 2.25 to 2.5 percent in 2016, (IMF: 2.6 percent, OECD 2.5 percent). Private consumption, services and construction are still thriving in the low interest rate environment, while capital expenditure and value creation in manufacturing and the energy sector remain under pressure due to the dollar and oil prices. Six out of eighteen manufacturing industries reported lower figures for the November and December Purchasing Managers’ Index. Industries in the energy sector are being hard hit by the low price of oil. There are manufacturing bright spots, however, such as the automotive and aerospace industries.

Japan’s growth outlook is seen improving by half a percentage point to just over 1 percent. Stuck in a severe recession, Brazil has recently seen its growth outlook slashed by 2.5 percent (IMF: minus 3.5 percent), and the outlook for Russia is not favourable either due to oil price trends (IMF: minus 1 percent). Venezuela, Nigeria and other oil-producing countries are facing substantially lower oil revenues, a situation that is having a concomitant impact on growth. Even though China is still slowing, Asia will again this year account for the lion’s share of global growth (Deutsche Bank 2016), with the US responsible for 10 percent and the euro area for at least 5 percent. There are some indications that emerging market countries may manage to eke out a growth rate increase of half a percentage point or more.

Forecast summary: Growth in real GDP 2015/16

	2014	2015			2016		
	IST	IMF[1]	OECD[2]	EU-COM[3]	IMF	OECD	EU-COM
World	3,4	3,1	2,9[4]	3,1	3,4	3,3[4]	3,5
USA	2,4	2,5	2,4	2,6	2,6	2,5	2,8
China	7,4	6,9	6,8	6,8	6,3	6,5	6,5
Japan	-0,1	0,6	0,6	0,7	1,0	1,0	1,1
EU	1,4			1,9			2,0
Euro area	0,8	1,5	1,5	1,6	1,7	1,8	1,8
Germany	1,6	1,5	1,5	1,7	1,7	1,8	1,9
France	0,2	1,1	1,1	1,1	1,3	1,3	1,4
Italy	-0,4	0,8	0,8	0,9	1,3	1,4	1,5
Spain	1,4	3,2	3,2	3,1	2,7	2,7	2,7
UK	2,9	2,2	2,4	2,5	2,2	2,4	2,4
India	7,3	7,3[5]	7,2	7,2	7,5[5]	7,3	7,4
Brazil	0,1	-3,8	-3,1	-2,6	-3,5	-1,2	-0,5
Russia	0,6	-3,7	-4,0	-3,7	-1,0	-0,4	-0,5

1: IMF (Januay 2016)
2: OECD (November 2015)
3: European Commission (November 2015)
4: Forecast on the basis of 70 percent world GDP (PPP of 2013)
5: Information on India for the fiscal year in current prices

BDI

China likely to stabilise somewhat in the course of the year

Despite all the volatility, the Chinese economy grew largely in line with estimates last year. Real growth came in just below the government's 7 percent target at 6.9 percent. A lesser figure could well have been expected given the turbulent events. The slowing of the economy is generally consistent with the fact that China must shift its economic model away from over-reliance on industry and construction by growing a dynamic service sector, increasing investment quality and avoiding a credit crunch.

Capital expenditure thus remained in a necessary correction at a year-on-year rate of increase of only 10 percent, a figure that is still somewhat high in view of the need for consolidation. Capital expenditure on manufacturing equipment increased 8.5 percent. In the real estate sector this figure was only 1 percent, revealing distinct consolidation, albeit no harsh adjustment. Manufacturing output has been losing momentum for 49 consecutive months, with growth now at just below 6 percent year-on-year. Steel production is declining, but still greatly exceeds demand, putting global steel prices under pressure. The structural shift over to services is proceeding apace however, with value added in the service sector up 8.3 percent, as compared to 6.1 percent in manufacturing.

The economy's relatively good performance reflects sound monetary and fiscal policy decision-making by the government. The economic stimulus package enacted by the Chinese government in autumn 2015, amounting to roughly 1.5 percent of GDP, in combination with monetary easing by the country's central bank have had the desired effect, so that the property market appears to have found a bottom; in major cities demand has rebounded noticeably, especially for office properties, thanks to a dynamic service sector.

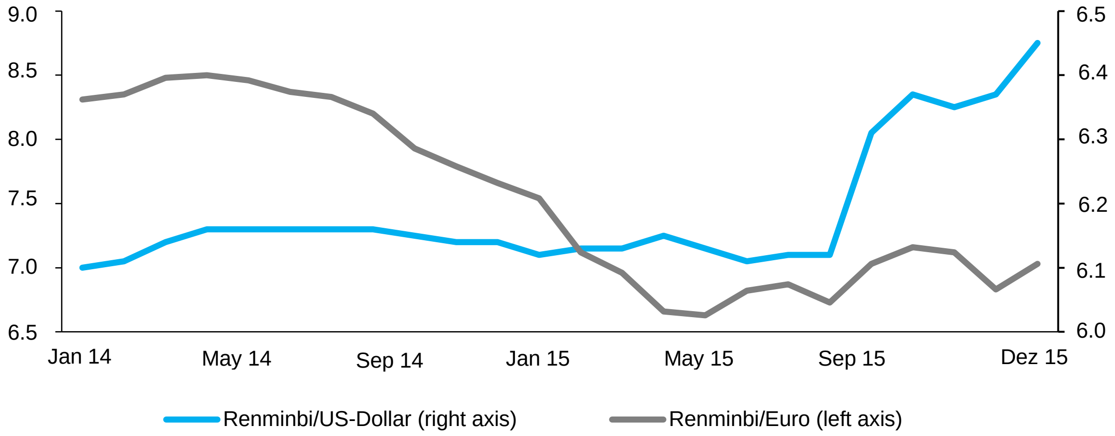
Outlook for this year

Year-on-year growth is projected to slow again in 2016 by around half a percentage point, with the IMF estimating a decline to 6.3 percent and the OECD 6.5 percent. Manufacturing is expected to remain weak in 2016 while services should propel growth. On 18 January 2016, the Chinese leadership adopted further fiscal stimulus measures including an investment package to expand high-speed rail with an equivalent volume of 100 billion euros. Good news can be anticipated in the areas of infrastructure investment by the central government, investments on the municipal level and services. Another positive is that the nation's property market is stabilising.

The Communist Party has yet to specify its target but the media have been talking about 6.5 percent as a possibility. What is clear is that if lending to the private sector is not reduced further, the credit crunch will probably become worse, something that Beijing is keen to avoid. Balance sheet consolidation in the real estate sector and among many state-owned enterprises and some private households which had bought flats to let as a retirement investment will remain top priority for a number of years. After two bouts of financial market turbulence, regaining investor confidence demands clear steps and signals regarding structural reforms that demonstrate a strong market orientation on the part of the country's leadership. The next key milestones on this path will be the National People's Congress in March and the upcoming publication of the five-year plan. The recent reform of the household registration system (hukou) did not accomplish that objective.

China's currency policy and the markets

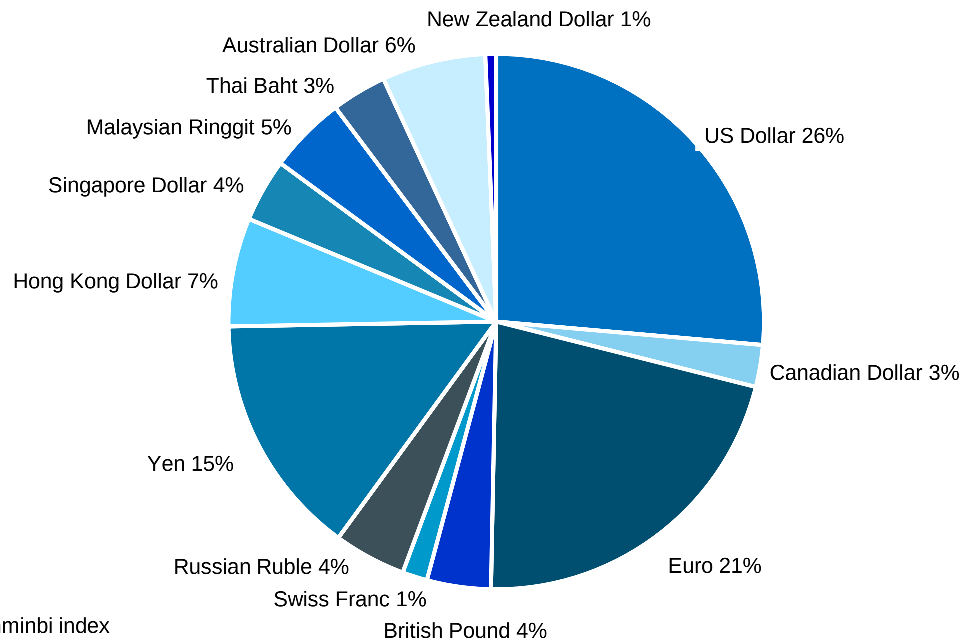
Movements in the renminbi`s exchange rate



Source: CEIC

China's foreign trade situation should remain largely unchanged. Although the country continues to have little vulnerability in foreign trade, its will still be careful to prevent erosion of its reserve position to the extent recently seen. China is expected to retain a current account surplus of at least 2 percent, which should lend sufficient stability to the huge wave of repayments of cheap foreign currency loans by Chinese debtors.

Currency basket of the Chinese Central Bank*



*CFETS Renminbi index

Source: German CFETS

The huge recent outflows of capital primarily represent redemptions of dollar-denominated debt of Chinese firms amounting to roughly half a trillion in US dollar loans repaid in the last six months, with another half a trillion following this year (Spencer 2016). However, many investors evidently attempted to move funds out of China in 2015. The Institute of International Finance found that roughly 216 billion dollars out of the total 676 billion dollars that left China last year likely represented circumvention offences (Financial Times 2016).

The markets will also have to adapt to the new exchange rate situation, because on 11 December 2015 the Chinese central bank published an exchange rate monitoring report relative to a basket of the 13 currencies of the country’s most importation trading partners (except South Korea and Taiwan) without indicating whether it constitutes binding policy (Bayoumi 2015 a, b, Spencer 2016). The market orientation adopted on 11 August 2015 has apparently been temporarily set aside in favour of central bank intervention to support the exchange rate against depreciation pressure in response to the stock and currency market turbulence in recent months. It remains to be seen if the situation will calm down, allowing a quick return to a market orientation. Depreciation against the dollar since the summer of 2015 amounted to only 6 percent as of late, and on a trade-weighted basis hardly anything has happened, especially not relative to the new basket. The country’s strong trade relationships in Asia must also be considered, for on a corresponding real trade-weighted basis the renminbi had appreciated around 20 percent prior to the recent correction rather than 30 percent (Zhang and Zeng 2016). The stock market volatility is without substantial immediate consequences, as only 6 percent of China’s population owns stock, most of which are shares of state-owned enterprises. Keep in mind that China accounts for 7 percent of Germany’s foreign trade and 5 percent of its FDI, even though only a handful of large German corporations derive a large percentage of their revenue from China.

Modest recovery in Europe continues

Europe’s economy will continue to slowly but steadily expand this year on strong domestic demand; an uptick in the global economy, mainly attributable to the industrialised countries; and further monetary and fiscal policy easing in Europe. Rising employment and the drop in oil prices are boosting consumption and counterbalancing companies’ weakening export performance as global demand slows, particularly in the emerging markets. The European Commission is predicting that the European Union will experience real GDP growth of 2 percent this year and 2.1 percent in 2017, and 1.8 percent and 1.9 percent respectively for the euro area. According to the latest IMF estimates, the euro area will grow 1.7 percent in both 2016 and 2017.

Consumption remains key growth driver

Last year, real GDP rose 1.9 percent in the European Union and 1.6 percent in the euro area. Consumption was the key growth driver, with consumer spending up 2.1 percent in 2015 year-on-year on an inflation-adjusted basis while government spending rose by 1.3 percent. This added 1.4 percentage points to the growth figure, a solid contribution. Capital expenditure increased by 2.9 percent, contributing 0.6 percentage points to growth. A considerable rise in CAPEX was only seen in a few European countries, including Spain, Ireland and the Netherlands. Exports rose by 4.8 percent, imports 5 percent. Net exports contributed 0.1 percentage points to growth. Weak demand from emerging markets remains a risk factor for foreign trade.

For this year the European Commission expects continuing moderate growth. The main economic driver will again be consumption, buoyed by another dip in oil prices and higher incomes. Government spending can be expected to increase as a result of the refugee and migrant situation. Corporate financing conditions will remain favourable this year due to low interest rates on bonds and loans, indicating potential for a rise in capital expenditure, which could somewhat offset lower exports.

Further labour market improvement

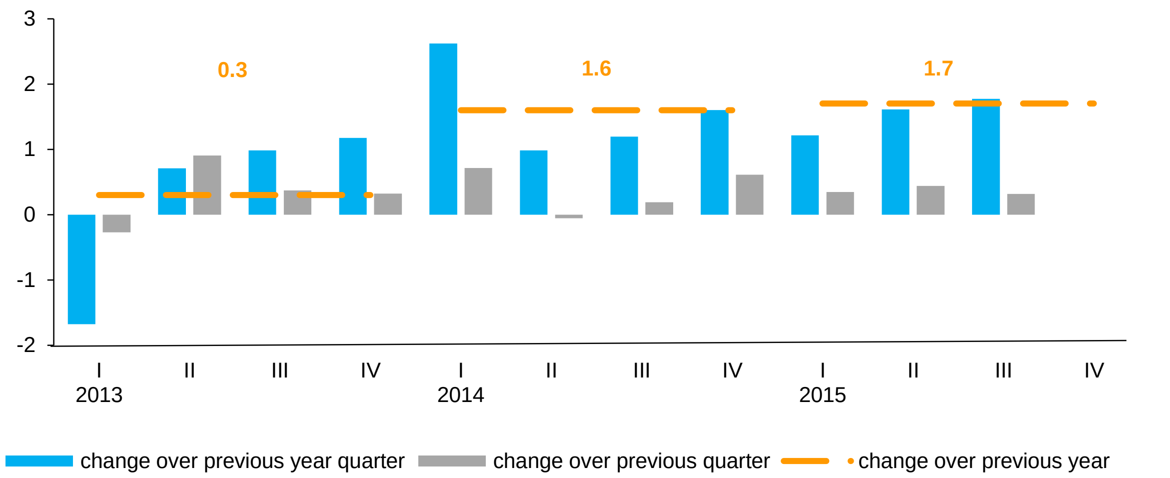
The European labour market continues to improve, although there are still large differences among member states. Unemployment has fallen steadily since 2013 to its present level of 9.1 percent (as of November 2015) – the lowest figure since July 2009. Germany again recorded the lowest unemployment rate of all the 28 EU member states (4.5 percent). The highest rate was 24.5 percent in economically battered Greece, followed by 21.4 percent in Spain.

The German economy

German economy still on track for growth

The German economy remains on a growth trajectory. **Gross domestic product** in the **third quarter of 2015** rose 0.3 percent quarter-on-quarter on an inflation, calendar and seasonally-adjusted basis. Year-on-year, growth is up 1.8 percent, as compared to 1.6 percent in the second quarter. A workforce of 43.2 million people in Germany generated this economic output, a number 0.8 percent higher than one year ago, representing an additional 340,000 workers. Except for agriculture and forestry and financial and insurance services, which saw declines of 2.7 percent and 2 percent respectively, gross value added rose across all sectors of the economy. The fastest growing sector was information and communications, up 2.9 percent; followed by corporate services, which gained 2.7 percent; and trade, transport and hospitality, all up 1.8 percent. Manufacturing value added increased by 1.4 percent.

Growth in real GDP, quarterly basis in percent



Source: Federal Statistical Office

Looking at the demand side, consumer spending contributed most to GDP growth, delivering 0.6 percentage points. On an inflation, calendar and seasonally-adjusted basis, household **consumption expenditure** increased by 0.6 percent quarter-on-quarter, while **government consumption expenditure** was up as much as 1.3 percent. Versus the previous quarter, **gross fixed capital formation** declined 0.3 percent. **Capital equipment spending** was particularly low, declining 0.8 percent after increasing for three quarters. **Construction investment** declined for the second year in a row (down 0.3 percent), but capital expenditure on other assets (patents, licenses, etc.) was up 0.6 percent versus the summer months. **Net exports** contributed to growth in the summer but trimmed 0.4 percentage points from GDP in the autumn quarter. Exports rose again slightly by 0.2 percent, but were significantly outstripped by imports, which increased by 1.1 percent quarter-on-quarter.

Surge in export income thanks to weak

In the third quarter of 2015, **exports** of goods and services were substantially higher than the same period last year (country-specific, seasonally adjusted figures were not available) despite weak emerging market growth. The weaker euro, which depreciated roughly 20 percent versus the US dollar in 2015 and 10 percent versus the British pound, led to a substantial gain in income from exports to countries outside the euro area. Third quarter exports were up 7.2 percent, an increase of 22.3 billion euros, versus the previous year. Almost half of this increase stemmed from trade with the United Kingdom (up 4.57 billion euros), the United States (up 4.07 billion euros) and the United Arab Emirates (up 1.38 billion euros). Income from trade with Poland (up 1.1 billion euros) and the Czech Republic (up 974 million euros) increased robustly. Within the euro area, exports rose by 2.57 billion euros to the Netherlands, by 1.1 billion euros to Spain and by 1 billion euros to Italy. Exports to China were 1.73 billion euros lower to due to the country's faltering economic growth. Exports to Russia fell by 1.67 billion euros, or 22.1 percent.

Imports in the third quarter increased 6.8 percent year-on-year, going up 15.18 billion euros. The largest growth in nominal terms came from trade with China (up 2.48 billion euros) and the United States (up 2.16 billion euros), followed by the United Kingdom and Poland, although exchange rate effects played more of a role in the sharp rise seen in the latter two countries than actual increases in volume. Imports from some European neighbour countries increased considerably. Goods imports from the Netherlands, Finland, Austria, France and Spain each rose by half a billion euros versus the same quarter last year. Imports from Russia fell by 1.67 billion euros, or 18.7 percent, in the same period. Imports from commodity-exporting nations like Algeria and Kazakhstan fell by nearly half, due largely to falling prices in the energy and commodity markets.

The latest data from November 2015 show exports increased 7.7 percent versus the same month last year. The increase in imports was slightly lower, at 5.3 percent. In the first eleven months of 2015, 6.7 percent more goods and services were exported overall than in the same period last year, measured in euros. Exports to EU countries outside the euro area rose significantly, climbing by 9.8 percent. However, this was likely due largely to the weaker euro. Goods exports to euro area countries were 5.9 percent higher than one year ago, and up 5.8 percent to non-euro area countries. Imports trended similarly, but with less momentum than exports, rising 4.2 percent in the first eleven months of the year. Imports from the EU rose, as did imports from non-EU countries, both increasing by 3.7 percent. Imports from EU countries outside the euro area rose 6.2 percent.

Preliminary data from the Federal Statistical Office show German **gross domestic product in 2015** rose by 1.7 percent on an inflation-adjusted basis. Economic output was thus above the average for the past ten years (up 1.3 percent), as in the previous year. Due to a greater number of work days, however, calendar-adjusted GDP growth was slightly lower, at 1.5 percent. All macroeconomic aggregates contributed to growth in 2015, led by government and consumer spending. The contribution of gross fixed capital formation and net exports was somewhat lower, at 0.3 and 0.2 percentage points respectively. Changes in inventories trimmed 0.4 percentage points from growth. This high figure indicates that an upward revision of the components is likely once the Federal Statistical Office releases its detailed findings. The result for the year shows that the German economy performed at its normal level in the fourth quarter, and is starting out the new year with a statistical overhang of around 0.5 percent.

Exports and imports in selected countries in Q3 2015
Year-on-year change

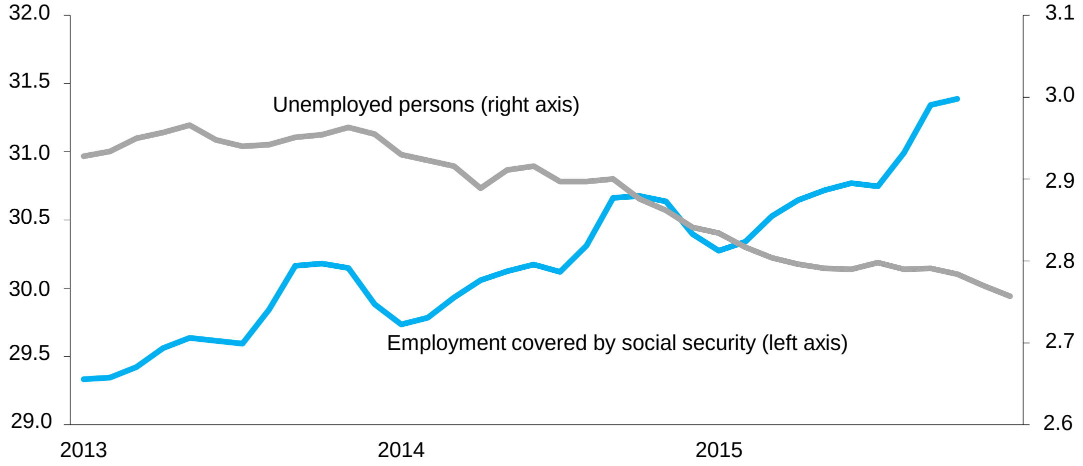
Increase (+) or decrease (-) in exports				Increase (+) or decrease (-) in imports			
	in million euros		in %		in million euros		in %
UK	22 641	+ 4 565	+ 25.3	**China**	24 059	+ 2 478	+ 11.5
USA	29 700	+ 4 072	+ 15.9	**USA**	14 492	+ 2 165	+ 17.6
Netherlands	20 438	+ 2 586	+ 14.5	**UK**	9 520	+ 1 976	+ 26.2
U. A. Emirates	4 188	+ 1 382	+ 49.3	**Poland**	11 202	+ 1 534	+ 15.9
Spain	9 407	+ 1 257	+ 15.4	**Netherlands**	22 516	+ 1 119	+ 5.2
Poland	13 317	+ 1 104	+ 9.0	**Switzerland**	10 482	+ 861	+ 9.0
Italy	14 007	+ 1 007	+ 7.7	**Finland**	2 558	+ 711	+ 38.5
Czech Republik	9 259	+ 974	+ 11.8	**Norway**	3 818	+ 659	+ 20.9
Turkey	5 600	+ 903	+ 19.2				
Austria	14 764	+ 851	+ 6.1	**Kazakhstan**	618	- 665	- 51.9
				Belgium	9 251	- 681	- 6.9
Russia	5 889	- 1 667	- 22.1	**Nigeria**	469	- 706	- 60.1
China	17 758	- 1 727	- 8.9	**Russia**	7 261	- 1 668	- 18.7
Total	**300 659**	**+ 20 296**	**+ 7.2**	**Total**	**237 924**	**- 15 182**	**+ 6.8**

Source: Federal Statistical Office

Further rise in employment

The German **labour market** showed very significant improvement again in 2015. According to the Federal Statistical Office, the average employment figure for 2015 was 43.03 million, representing a 0.8 percent year-on-year increase, or an additional 342,000 workers. This change mainly reflects a rise in the number of **employees paying into the social security system**. According to preliminary data, as of October 2015 (latest available data) the number of such employees increased by 2.3 percent, or 713,000, within a one-year horizon to 31.39 million. Nearly every industry posted employment gains. The most hiring was seen in the segments nursing and social work, trade, car maintenance, other commercial services and skilled corporate services. The number of employees in mining and energy decreased slightly. At the end of 2015, 2.681 million people were registered as **unemployed**; this figure was 48,000 more than in November, but 82,000 less than one year ago. The **unemployment rate** in December was 6.1 percent, down 0.3 percentage points from one year ago.

German labour market*



*seasonally adjusted, in million

Source: Federal Employment Agency

Incoming orders and manufacturing

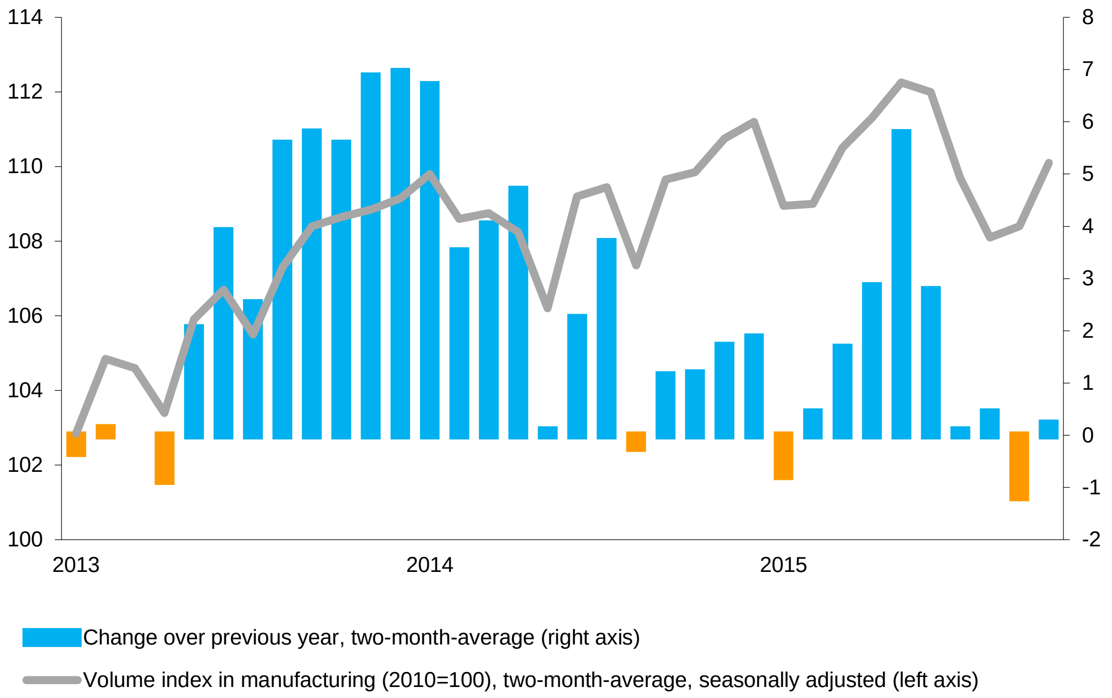
New orders show upward trend

A 1.5 percent month-to-month increase in **manufacturing orders** was recorded for November 2015 according to preliminary data (after inflation, calendar and seasonal adjustments). In October orders rose 1.7 percent. Large order volume was slightly below average in November. Domestic orders increased by 2.6 percent, while foreign orders only rose 0.6 percent, with the impetus coming from non-euro area countries (up 1.4 percent). Orders from the euro area decreased slightly month-to-month.

A **two-month comparison**, which smooths out volatility, shows that orders rose 2 percent in October/November 2015 versus August/September 2015, after having declined from August to October. Strong incoming orders in the first half of the year pushed orders in 2015 up slightly more than 1 percent versus the previous year. For the first time since 2009, domestic business outperformed foreign business over a one-year period, and euro area demand exceeded non-EU demand.

Producers of **intermediate goods** fared best among the main groups of industrial goods, receiving 2.4 percent more orders in a two-month comparison of October/November versus August/September. Domestic demand rose 1.9 percent, while foreign orders were even stronger (up 2.9 percent). Incoming orders were somewhat weak, thus orders in 2015 probably exceeded last year's level only slightly.

New orders, manufacturing



Source Federal Statistical Office

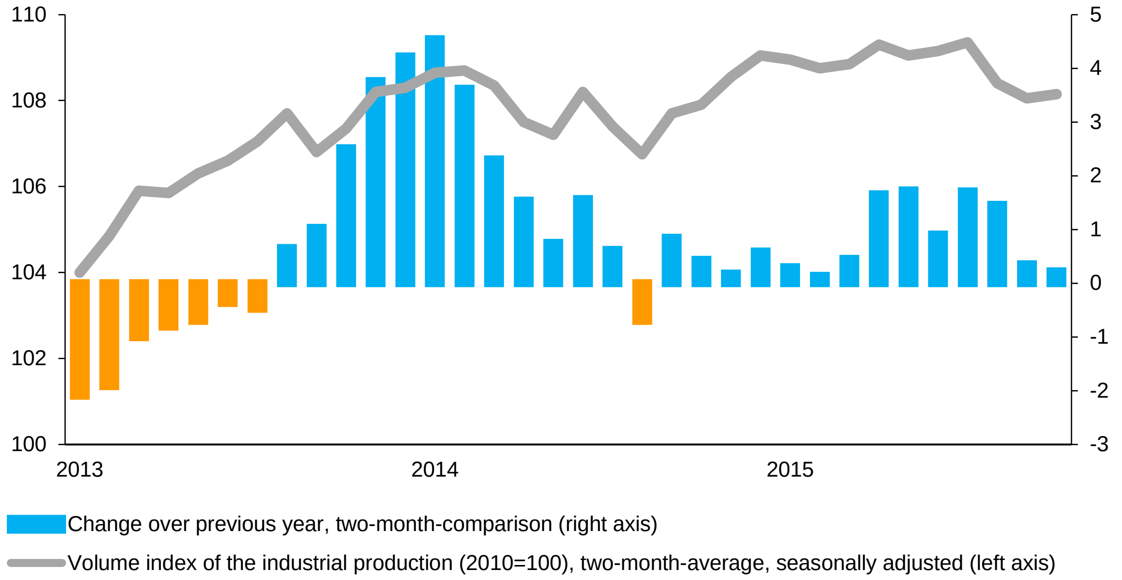
Demand for **capital goods** in the period October/November rose 1.7 percent compared to August/September. Domestic orders were the primary source of capital goods demand, which rose 3.1 percent over the previous period. Foreign demand increased slightly by 0.8 percent after three consecutive declines. For the year capital goods demand is estimated to have risen approximately 1.5 percent. Foreign demand will reach the previous year's level, and domestic orders should be up for the first time in five years.

Makers of consumer goods recorded a 3.4 percent increase in new orders in the two-month comparison of October/November versus August/September. As in the previous month, foreign demand was the main driver (up 4.7 percent; domestic demand: up 1.6 percent). An increase of around 3 percent is expected for the full year, with domestic and foreign demand roughly equal in strength.

Production down slightly at year end

Preliminary data show **production in manufacturing** (including energy and construction) declined 0.3 percent month-on-month in November 2015 (unless stated otherwise, all figures are after inflation, calendar and seasonal adjustments). After an upward revision, a 0.5 percent production increase was recorded for October. While energy production and production in the construction sector increased by 2.5 percent and 1.6 percent respectively in November, industrial production experienced a decline of 0.8 percent. Production of intermediate and consumer goods rose 1.1 percent and 1.9 percent respectively, while capital goods production declined 3.3 percent month-to-month.

Industrial production



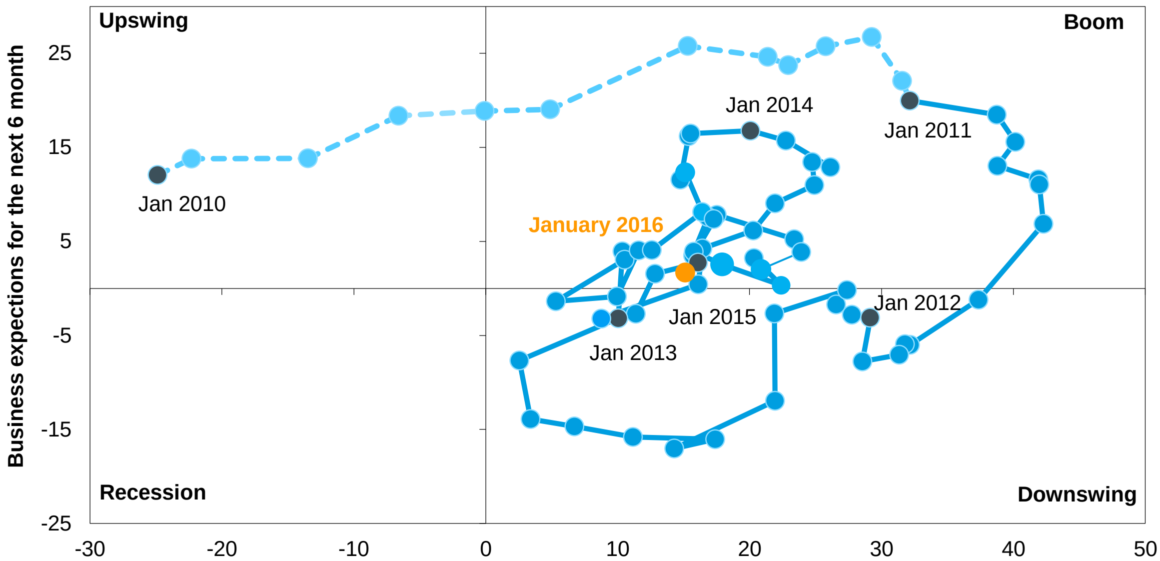
Source: Federal Statistical Office

In a **two-month comparison**, which smooths out volatility, production in manufacturing saw a slight decline of 0.2 percent. The previous-year's level was exceeded on a full-year basis, with the projected production increase for the year being roughly 1.5 percent. Construction output increased 1.4 percent, in a two-month comparison as well, and is projected to exceed the previous-year's figure by a bit more than 1 percent.

Industrial production was nearly unchanged in a two-month comparison (down 0.2 percent). Within the main manufacturing sectors, producers of intermediate goods recorded a 0.4 percent production decrease. Makers of consumer goods produced 0.8 percent less. Capital goods production rose 0.2 percent, Production of industrial goods slowed in the second half, but the previous-year's level was met or exceeded in most months of the year, so for the full year industrial production is estimated to be up just above 1 percent. Looking at the main manufacturing sectors, capital goods and intermediate goods producers are estimated to have increased production by as much as 1.5 percent for the year. Full-year consumer goods production is projected to slightly exceed the previous-year's level.

In the final quarter of last year the **Ifo Business Climate Index** for **industry and trade** tracked two minor declines, both associated with more negative assessments of the current business situation. Since September 2015, however, companies' business expectations have steadily brightened. The business climate for manufacturing has rebounded considerably after a brief weak period in late summer, with the expectations component being the driving factor. Neither the terrorist attacks in Paris, the refugee crisis nor tepid emerging market growth had a sustained impact on the mood of German businesses through the end of 2015. At the start of this year, however, the mood among manufacturers deteriorated significantly. The Ifo Business Climate Index for **industry and trade** registered its sharpest decline in one and a half years, falling 1.3 percentage points. Although firms' view of the current business situation was hardly changed, they significantly lowered their expectations. For **manufactures** the business climate index fell to its lowest level in a year. The status quo opinion deteriorated only slightly here as well, as capacity utilisation was higher. Manufacturing firms revised their expectations considerably, due chiefly to dimmer export projections.

ifo Business-Cycle Clock
Germany, manufacturing*



* Balances, seasonally adjusted

Source: ifo Institut

Outlook

Many uncertainties but conditions good

The German economy started out this year in a similar situation as January last year, with employment at a high level and unemployment low. This will provide support to consumer spending over the course of the year, while the further slide in oil prices should keep inflationary pressures in check. The weak euro should have a positive impact on income from exports outside the euro area, at least during the first half of the 2016. The German economy is also starting out the new year with a statistical overhang of about 0.5 percent. Even if economic output were to stagnate over the course of the year, growth would still stand at 0.5 percent in a year-on-year comparison.

The German economy will be driven primarily by domestic factors this year. The main domestic driver is **private consumption**, which is supported by continuing labour market growth, rising wages and low inflation. Giving consumer demand a further boost will likely be the pension adjustment scheduled for the summer of 2016, which will increase retirees' income by just over 4 percent in the old and about 5 percent in the new German Länder respectively. Disposable incomes are expected to rise by approximately another 3 percent, creating corresponding positive sentiment in certain mood indicators. The consumer climate index tracked by consumer research organisation GfK showed another slight rise going into 2016 from an already high level. Consumer expectations rose significantly concerning both the economy and income. According to the Ifo Institute, the business climate in retail changed little, as the most recent data indicate retailers are slightly less satisfied with the current industry situation, although business expectations moved into positive territory. All things considered, household consumer spending will likely increase by another 2 percent this year.

The **public sector** should spur demand as well, as spending on refugees alone could total 15 to 20 billion euros according to rough estimates. Government spending is projected to rise 3 percent overall, after a 2.8 percent increase last year.

Capital expenditure projections are subject to the most uncertainty, while construction spending is set to increase the most. In addition to rising demand for refugee housing, household incomes are advancing and mortgage rates remain low, providing continuing stimulation for housing construction. Business expectations in the construction sector are correspondingly positive. Mortgage loan approvals have increased in recent months, and public sector construction is set to revive this year thanks to spending packages adopted by the German government. It will be investing more in roads, railways and waterways, and provide additional investment funds to cash-strapped municipalities. The construction industry sees a relatively dim outlook for commercial construction, as German firms are not investing enough in new factories. Total construction spending is still projected to rise by around 2.25 percent in 2016.

The forecast for **capital equipment spending** is considerably more difficult. Low interest rates and stronger corporate balance sheets mean conditions are favourable for additional investment, although geopolitical risks and Chinese stock market woes pose worries for businesses. The ECB's latest Bank Lending Survey, however, indicates that CAPEX may pick up a bit in Germany, as corporate lending is up. Manufacturing capacity utilisation recorded its highest level in four years at the start of 2016, rising 0.6 percentage points to 85.1 percent. Consequently, not just replacement but also expansion spending may be seen if economic growth slightly accelerates. Capital equipment spending was up a solid 3.6 percent in 2015, although this was slightly lower than the increase recorded in 2014 (up 4.5 percent). If German exports continue to revive despite the persistence of major foreign trade concerns, another 3.5 percent increase is realistic. Expenditure on other assets (software, R&D) is generally stable, and is expected to grow by 2.5 percent (2015: 2.7 percent).

Positive factors affecting **foreign trade** include the economic recovery in Europe and the steady growth in the US and UK. Both countries saw substantial rises in export income in the second half of last year. This trend is expected to continue into the middle of 2016, and should help offset flagging demand from emerging markets, particularly China and Russia. Owing to the somewhat subdued pace of global economic expansion, German exports will not rise as fast as they have in recent years. Imports will outstrip exports due to strong consumption and supply chain-induced demand, so foreign trade will probably not contribute to growth. We project a 4.5 percent real increase in exports of goods and services and 5.3 percent in imports; both figures are below the previous-year's values (2015: 5.4 percent and 5.7 percent respectively). This year's GDP should expand at an annualised rate of 1.9 percent, provided that global economic conditions remain more or less in line with forecasts.

Actual figures for 2014/2015 and estimated figures for 2015

	2014	2015	2016
Gross domestic product	1.6	1.7	1.9
Private Consumption	0.9	1.9	2.0
Investment	3.5	1.7	2.7
- Machinery and Equipment	4.5	3.6	3.5
- Construction	2.9	0.2	2.3
- Other	3.1	2.7	2.5
Exports	4.0	5.4	4.5
Imports	3.7	5.7	5.3

Source: Federal Statistical Office, own calculation

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Basic data for national accounts

GDP (price, seasonally and calendar adjusted)
Change over previous period in percent

			2014		2015		
	2014	2015	Q3	Q4	Q1	Q2	Q3
Consumption	1.1	2.1	0.6	0.8	0.4	0.3	0.8
Private Consumption	0.9	1.9	0.6	1.0	0.4	0.1	0.6
Public Consumption	1.7	2.8	0.6	0.5	0.4	0.7	1.3
Investment	3.5	1.7	-0.7	1.3	1.7	-0.4	-0.3
Machinery and Equipment	4.5	3.6	-1.9	2.6	1.9	0.5	0.8
Construction	2.9	0.2	-0.4	0.6	1.8	-1.3	-0.3
Other	3.1	2.7	0.6	0.7	0.8	0.7	0.6
Domestic Demand	1.3	1.6	-0.4	1.0	0.5	-0.2	0.7
Exports	4.0	5.4	1.5	1.4	1.5	1.8	0.2
Imports	3.7	5.7	0.4	2.3	2.1	0.5	1.1
Total	1.6	1.5	0.2	0.6	0.3	0.4	0.3

Contributions to growth (in percentage points)

Consumption	0.9	1.6	0.5	0.6	0.3	0.2	0.6
Private Consumption	0.5	1.0	0.4	0.5	0.2	0.1	0.3
Public Consumption	0.3	0.5	0.1	0.1	0.1	0.1	0.2
Investment	0.7	0.3	-0.1	0.3	0.3	-0.1	-0.1
Machinery and Equipment	0.3	0.2	-0.1	0.2	0.1	0.0	-0.1
Construction	0.3	0.0	0.0	0.1	0.2	-0.1	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic Demand	1.2	1.5	-0.4	0.9	0.5	-0.2	0.7
Net Exports	0.4	0.2	0.5	-0.3	-0.1	0.6	-0.4

Source: Destatis