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GERMAN ECONOMY IN 2017: STABLE, BUT NOT STAID

COFACE ECONOMIC PUBLICATIONS

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The signs for Germany's further economic development are promising, with a high level of stability. Coface's expectations for solid growth therefore come as little surprise. This year's gross domestic product is expected to grow by 1.8 % (seasonally adjusted and corrected for working days). Growth for next year, at 1.7 %, will only be marginally smaller. Since 2015, Germany's economy has been growing faster than the potential of 1 to 1.5 % set by the German Bundesbank and several research institutions.

The primary growth driver for 2017 will once again be private consumption, mainly fuelled by the country's record-high levels of employment. Consumers' purchasing intentions will gain additional impetus, although less so than in 2016, due to lower increases in real wages resulting from rising inflation.

The main focus for 2017 will be on the political arena, with presidential elections in France and the Bundestag elections in autumn. The five federal state elections this year are considered important indicators for the upcoming federal elections and it can be expected that the future Federal Government – whatever its colour – will be less powerful than the current "Grand Coalition". This will restrain reforms to a minimum level.

Risks for the German economy could also occur on the export side. Global trade is only expected to show moderate growth in 2017 and specific risks are lurking in some of the major target countries for German exports – such as the forthcoming Brexit and the cooling down of the Chinese and US economies. Insecurity could also rise in the aftermath of the US presidential elections. German exports will only grow by 2.3 % in 2016 and 3.4 % next year.

In this environment, Coface forecasts that the downward pressure on insolvencies will continue, with the fifth year in a row of record lows in 2017 (falling to a volume of around 21,000). Nevertheless, this downward trend is expected to continue at a slightly slower pace. After decreasing by 5% this year, Coface forecasts a further decline in bankruptcies by 4.2 % in 2017. Despite the positive outlook, the amount of outstanding claims in insolvency procedures could rise further, as several sectors, especially large companies, are under increased pressure from competition, costs and profit margins.

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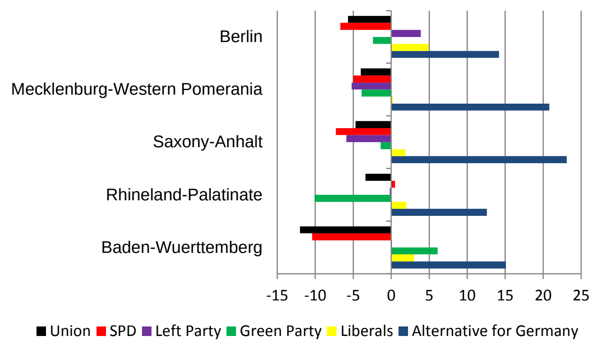
"The stable outlook for the German economy does not mean that companies in Germany will be able to lower their guard in the coming year. There are a number of external risks which could particularly affect Germany's export-oriented economy. In addition, after the reform fatigue of the Grand Coalition, we cannot expect to see new far-reaching economic policy measures from the next government. These uncertainties will dissuade companies from extending their investments beyond manageable limits in the coming year."

1 GERMANY'S PARLIAMENTARY ELECTIONS IN 2017: THE NEXT GOVERNMENT WILL BE WEAKER THAN THE CURRENT ONE

The established forces are rapidly losing support in Germany's federal state elections

2016 was a 'super election year' with a total of five federal state elections. Amongst these were Baden-Wuerttemberg (Germany's third largest federal state in terms of number of inhabitants), along with Rhineland-Palatinate, Berlin, Saxony-Anhalt and Mecklenburg-Western Pomerania (respectively the 7th, 8th, 11th and 14th largest). These elections mean that nearly 30 % of German citizens have been called to the polls. The results thus provide a comprehensive picture of the voter mood in advance of the upcoming federal elections next year.

Chart 1:
Gains and losses (in percentage points) of the largest parties in the five federal state elections 2016



Source: Statistical offices, Coface.

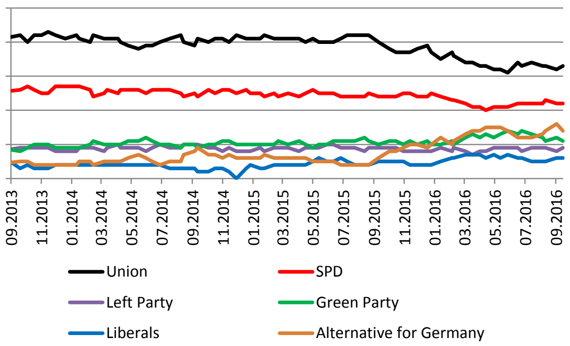
The resulting picture is almost unanimous. Amidst a distinctly higher voter turnout there was one big winner across the federal state boundaries: the 'Alternative für Deutschland (AfD)' *(Alternative for Germany*). The AfD, with its right wing populist anti-immigration and Eurosceptic programme, achieved solid double-digit results from a standing position. Conversely, the country's two main governing parties, the CDU and SPD, suffered heavy losses in almost all federal states, with sharp two-digit declines for both parties in Baden-Wuerttemberg. This means that in federal states such as Baden-Wuerttemberg and Saxony-Anhalt, the main parties have shrunk to such an extent that even a Grand Coalition could no longer attain a majority.

Will the Grand Coalition come to an end in 2017?

The parties of the governing coalition are unlikely to escape unscathed during next year's elections. According to current surveys, both the Union and SPD parties are scoring lower than the results they achieved during the last parliamentary elections (of September 2013). They are also below the survey results taken at the turn of the year 2015/2016.

Nevertheless, the overall picture for the future of the Federal Government reflects stability and anything other than a renewal of the Grand Coalition would be a surprise, as all available surveys still show that the Grand Coalition has a margin of security to obtain an absolute majority, while there is no majority for any other coalition of two parties. Even a tripartite alliance of the SPD, Left Party and The Greens, which has been sought by several groups, would have little chance of obtaining absolute majority.

Chart 2:
Results of the "Sonntagsfrage" poll question ("If the Bundestag election were next Sunday, for which party would you vote?") on the parliamentary election (figures in per cent)



Source: infratest dimap, Coface.

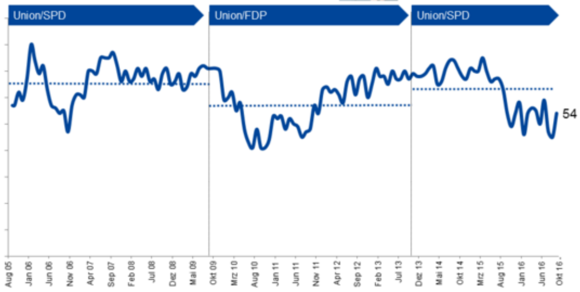
The decline in support for the governing parties' policies is being fuelled by increasing scepticism towards Federal Chancellor Merkel and her policies on immigration and refugees. This has led to a widespread decline in Chancellor Merkel's personal approval rating, which weakens her position as a domestic and European anchor of stability. This will be particularly apparent if the Bundestag election in 2017 results in a smaller majority for the Grand Coalition. Nevertheless, despite anticipated losses for the Union parties and the increasing difficulties faced by Chancellor Merkel, she will once again be at the helm of the next (although smaller) edition of the Grand Coalition.

Political Insecurities have increased in Europe and are weighing on economic growth

In one of its Panoramas, Coface analysed to what extent increased political uncertainty drags on Europe's economic growth. Coface has created a new Political Risk Indicator, which indicates a rise in political uncertainty for all analysed EU-countries between 2007 and 2016. Additionally, by using the Economic Policy Uncertainty Index, Coface estimates a dampening GDP growth impact of 0.2 percentage points during recent years, due to higher political uncertainties following the Lehman crisis. Corporate investment is the main transmission channel. Against the backdrop of upcoming key political events in Europe, such as the presidential elections in France and Germany's parliamentary elections, if political uncertainty rises as much as it has in the UK following the referendum, this could lower GDP growth by around 0.5 percentage points next year.

See Coface Panorama, October 2016: "European economies: Will political risk spoil the party in 2017?"

Chart 3:
Satisfaction with Federal Chancellor Merkel (figures in per cent)



Source: infratest dimap.

Far-reaching reforms will become more difficult

A smaller Grand Coalition – as well as the likelihood of the AfD being an additional political power in the Bundestag - will hamper political consensus. For the first time since 1953, six parliamentary groups, covering a very broad political spectrum, will be represented in the Bundestag. Moreover, as the leaders (Merkel for the Union and Gabriel for the SPD) are anything but undisputed, under the next Grand Coalition, large reform projects – including those covering economic and social policy – will become more and more difficult.

Despite the clear majority in the Bundestag, the government's ambitions for reforms have lost some momentum over the last two years. As an illustration, the Bertelsmann Foundation's Sustainable Governance Indicators, which compare the political and economic policy frameworks of 41 EU and OECD countries, show that economic policy in 2016 is slightly lagging behind the results for 2015. Nevertheless, Germany is still among the top nations, ranking in 5th position among the 41 countries analysed. According to Bertelsmann Stiftung, the reasons for Germany's slightly weaker assessment this year are extended regulations (in the context of the introduction of minimum wages) and the country's generous decisions on pension policies (with additional pension payments for mothers and the pension age at 63).

Once again, the overall assessment of social policies has not improved over the last two years, resulting in Germany being ranked 12th among the 41 evaluated countries. Major challenges are the country's expensive health system and the integration and financing of the huge number of refugees and immigrants. In its Autumn Report, the leading research institutes called upon the Federal Government to focus on a reorientation of the market economy. Public expenditure needs to proactively support investment, rather than consumptive purposes.

Germany is thus experiencing a similar political situation to many other EU countries, with right-wing populist parties such as the AfD gaining ground, while established (large) parties are losing much of their support.

A weakened Federal Government and a weakened Chancellor Merkel are having their impact felt on the European political arena. Controversial guidelines for far-reaching reforms above the political party level are unlikely to be agreed in a fragmented parliament and this could lead to a weakened negotiating position for Germany in European public policy issues.

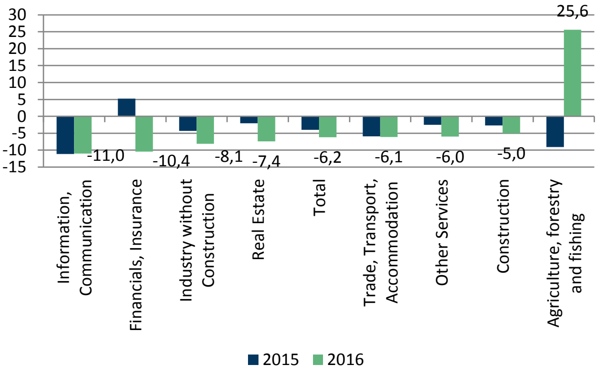
These potential risks for political developments in Germany could fuel political uncertainties in the European community, creating an additional drag on consensus-building at European Union level.

2 STABLE ECONOMIC ENVIRONMENT LEADING TO FEWER INSOLVENCIES – AGAIN IN 2017

Downward trend in corporate insolvencies gathered speed up to August 2016

The figures for the first eight months of 2016 showed the fall in corporate insolvencies continuing to gather speed, following on from the downward trend which began in 2009. While the number of insolvencies in 2015 was 4 % lower than in 2014, up to August 2016 they were more than 6 % lower than for the same period a year earlier. Corporate insolvencies are thus heading for a new record low this year.

Chart 4:
Development of insolvencies, by sector, in the first eight months of 2016 (year-to-date, in percent), as well as in the total year 2015 (change from 2014, in per cent)



Source: Destatis, Coface.

At first sight, these developments are positive, without exception. A different view of the Destatis figures, however, reveals that up to August 2016, the receivables expected to be affected by initiated insolvency proceedings clearly exceed those of the first eight months of 2015. At a volume of almost EUR 20 billion, they are over 70 % higher than last year's receivables. The reason for this is that there are more insolvencies among economically larger companies, such as Steilmann and Unister, despite a decreasing number of insolvencies in absolute terms. Receivables in insolvency proceedings rose especially strongly in the sectors Freelancers, scientific and technical services to almost EUR 8 billion, in the industry (without contruction) to nearly EUR 4 billion and in trade sectors to more than EUR 2 billion. In Agrofood, claims rose significantly as well. But outstanding amounts are quite small by volume (a good EUR 0.5 billion).

A more differentiated view is also recommended for developments in the business sectors over the first eight months of 2016. The reduction in corporate insolvencies across the German corporate landscape comes as good news – with just one exception.Following a 9.1 % reduction in bankruptcies in agriculture, forestry and fishing reported for 2015, the number shot up by over 25 % between January and August 2016. On the other hand, the sectors of Finance and Insurance, as well as Information and Communications, have seen a distinct reduction, by nearly two-digit percentage points each, during 2016 so far.

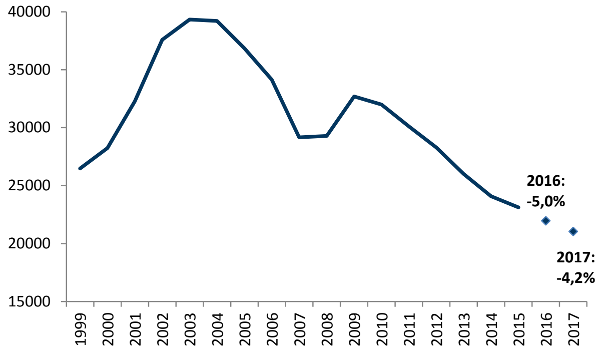
The Coface forecast model for insolvencies, with an assessment of the development of insolvencies in relation to the growth forecast for the gross domestic product[1], predicts a further reduction in insolvencies (-5 %) for this year. This means that the downward trend will only show a slight deceleration compared to the rate seen up to August 2016. This gives Germany a more positive forecast for this year compared to the latest Coface insolvency study for the Northern Europe Region, which foreasts a reduction of 'just' 2.5 % in insolvencies for this year.

2017: Insolvencies expected to slow further

The robust state of the German economy and the positive sentiment in the corporate sector are expected to be mirrored by a continued fall in insolvencies over the coming year. The Coface forecast model anticipates the eighth consecutive reduction (albeit slightly weaker than before) at -4.2 %. With a volume of around 21,000 expected at the end of 2017, the number of corporate insolvencies should be 36 % lower than the peak recorded in 2009 – a year when nearly 33,000 companies submitted applications for insolvency proceedings to German courts.

1. See Coface Panorama, June 2016: "Business Insolvencies in Northern Europe: slower decrease in 2016".

Chart 5:
Number of corporate insolvencies in Germany, from 1999 to 2017



Source: Destatis, Coface. Forecasts for 2016 and 2017.

There are, however, risks which could dampen the reduction in insolvencies forecast. These risks mainly relate to companies which have a high dependence on exports. The cooling down of the US economy and the concretisation of the Brexit could both have negative impacts – especially as these two countries are among Germany's five most important export destinations.

In addition, there is the threat that could gloom a shadow over private household consumer confidence, due to continued insecurities. This would lead to a more difficult environment for the German corporate sector from a domestic point of view, which would put pressure on insolvency figures.

Furthermore, another trend which could continue in the new year is an increase in the aggregated volume of claims. Therefore, although the probability of insolvencies is expected to fall further, the severity of potential claims could be higher again in 2017. In a sectorial view, the severity could continue to be disproportionally higher in Trade, for freelancers and for enterprises in manufacturing.

Business insolvencies in Europe: In most countries, bankruptcies are expected to decline further in 2017

According to Coface forecasting models, insolvencies will continue their downward trend in most European countries over the coming year. However, in Denmark, Switzerland and the United Kingdom, insolvencies are already rising this year and will increase further in 2017.

Development of Corporate Insolvencies

	2015	2016	2017
Belgium	-9.0%	-12.0%	-6.0%
Denmark	-0.5%	+63.3%	+34.4%
Finland	-13.0%	-4.0%	-2.0%
France	+1.0%	-4.0%	-1.0%
Italy	-7.0%	-8.0%	-5.0%
Netherlands	-20,7%	-15,9%	-3,5%
Portugal	+12.0%	-8.0%	-3.0%
Spain	-24.0%	-20.0%	-12.0%
Sweden	-11.3 %	-4.3 %	-3.6 %
Switzerland	-1.0%	+4.0%	+2.0%
United Kingdom	-10.0%	+1.0%	+8.0%

Source: Thomson Reuters Datastream, Coface. Forecasts for 2016 and 2017.

3 SLUGGISH GLOBAL TRADE DAMPENING GROWTH POTENTIAL FOR GERMAN EXPORTERS

Growth rate of German exports clearly slowing since the second half of 2015 …

Despite another record year – measured against the export volume – for German goods' exports in 2015, growth rates have distinctly contracted since the second half of 2015. In the first quarter of 2016, the growth of German exports came to a near standstill, due to the slight decline in the volume of world trade for the first time since autumn 2010. The subsequent recovery has been far from dynamic.

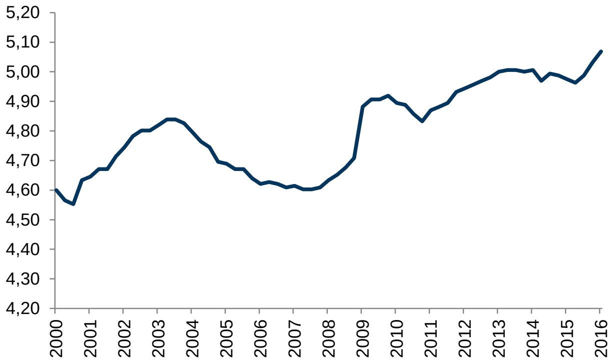
Chart 6:
Growth of the world trade and German exports between 2006 and 2017

Source: World Trade Organisation (WTO), Coface. Forecasts for 2016 and 2017.

The health of Germany's economy, which is heavily reliiant on its successes in foreign trade, is being impacted by the challenging climate of global risk. Added to the threats of terrorism and armed conflicts which are putting a strain on global economic activities, there are the volatility of commodity prices, political risks such as the forthcoming Brexit and maybe in liaison with Trump's stance in economomic policy[2], increasing protectionism[3] and weakening growth in various emerging market economies such as China in particular.

It is therefore no surprise that global risks have reached an all-time high, according to the Coface country risk assessment. This heightened level of uncertainty is dampening the investment activities of companies around the globe – as reflected in the anaemic growth of world trade, which is affecting German exporters.

Chart 7:
Average global country risk



Source: Coface. 1 corresponds to the Coface country rating A1 (very low risk), 8 corresponds to E (extremely high risk).

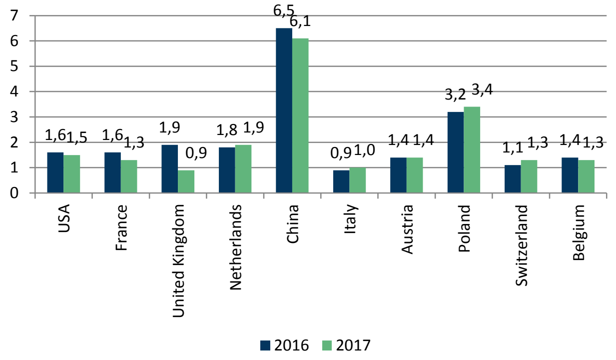
… and will only recover in small steps by 2017

The fact that Germany's economy is heavily dependent on the development of global trade, is shown in the Coface model which mirrors the relationship between growth in German exports and the development of world trade. German exports show a disproportionately strong reaction to the vicissitudes of world trade, in particular in cases of sharp upswings or drops. As an illustration, at the peak of the global financial and economic crisis between 2008 and 2009, German exports fell considerably faster than overall world trade. The opposite case was seen during the subsequent fast recovery of global trade in 2010/2011, when the business of German exporters significantly outgrew world trade volume.

In the first half of 2016, both world trade and German exports were very weak. German exporters recorded a slight upturn in the second quarter, due to the mild growth of world trade. However, the World Trade Organisation WTO only expects an increase of 1.7 % in world trade volume compared to 2015. This would be the weakest growth since the collapse of global trade volumes during the crisis of 2009. According to Coface's model, this would correspond to a growth of just 2.3 % in German exports, again resulting in a new record of total export volume for 2016. The growth rate is, however, expected to be distinctly weaker than in 2015. Despite the business slowdown in the second half of 2015, an export gain of 6.4 % was reached for 2015 as a whole.

2. See Coface Panorama, October 2016: "European economies: Will political risk spoil the party in 2017?".
3. See IMF World Economic Outlook, October 2016.

Chart 8:
Economic growth in Germany's ten most important export countries for 2016 and 2017 (figures in per cent)



Source: Coface. Forecasts for 2016 and 2017.

The outlook for German exports in 2017 is cautiously optimistic. The World Trade Organisation anticipates a continued weak momentum in global trade volumes, with an increase of between 1.8 and 3.1 % for 2017. This corresponds to an average forecast of just under 2.5 %. Using the Coface model for German exports, this will correspond with a growth of 3.4 % in German exports for 2017. Nevertheless, the downward risks prevailing in the countries of importance for German trade should be taken into account.

An analysis of the economic prospects in 2017 for the top 10 target countries for German exports reveals a weaker trend than in 2016. Around 60 % of all German exports are sold to these countries. The economic slowdown in four of the five most important target countries will be of particular relevance. For the UK, the third biggest target country, Coface expects a massive slump in growth, down from 1.9 to 0.9 %, largely due to the Brexit. This is expected to seriously affect German exports. In China, the gradual slowdown in growth is expected to continue – as is the gloom in the USA – now Germany's most important customer, accounting for a share of around 9 % of all exports. France, Germany's second largest export destination, is expected to suffer from another slight setback in economic growth in 2017.

These negative impacts will be partially compensated for by the slightly improved economic outlook for the remaining countries of the top 10 group, along with clearly higher growth expected for emerging and developing countries – which account for around 30 % of German exports. Coface forecasts that these countries will continue their upward trend in economic growth in 2017. Since the growth rate for emerging and developing countries hit rock bottom in 2015, at an average of +3.4 %, Coface forecasts a growth rate of 3.7 % for 2016 and 4.2 % for 2017 – to exceed the 4 % threshold for the first time since 2014. This should lead to the growth of German exports to emerging and developing countries in 2016 and 2017, which would distinctly outweigh that of exports to industrial countries. In the two previous years of 2014 and 2015, the established advanced economies were still the main growth drivers for Germany's export industry[4].

Evaluating relationships between world trade and German exports

To analyse the relationship between German exports and global trade, Coface used a simple regression model. The sole explanatory variable used for the growth in German goods' exports was the change in world trade volumes from the World Trade Organisation WTO, without using a constant. The relationship is highly significant and the corrected coefficient of determination is almost 90 %, while the regression coefficient is 1.364. Each percentage point of growth in global trade thus corresponds to an increase in German export volumes of 1.364 percentage points. German exports therefore react disproportionally to developments in global trade.

4 PRIVATE CONSUMPTION TO REMAIN THE MAJOR GROWTH DRIVER IN 2017

Real wage growth will moderate in 2017 …

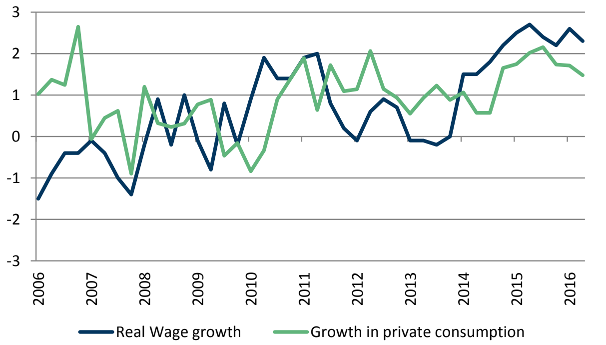
The solid growth prospects for the German economy mainly rely on the dynamic pace of private consumption. According to Coface forecasts, private household consumer spending will further accelerate in 2017, to reach a high of 2.0 % – up from 1.9 in 2015 and 1.6 % in 2016.

To put this into perspective, the average growth in private consumption between 2006 and 2014 was just 0.8 % and the growth of the German economy mainly relied on net exports.

In 2017, growth impulses from net exports are expected to be completely lackluster and could even slightly slow. Coface forecasts that these strong dynamics in private customer spending will ensure growth in gross domestic product of 1.7 %, by contributing two-thirds (or 1.1 percentage points).

4. See Coface Panorama, March 2016: "The German economy: Safe inside, riskier outside".

Chart 9:
Evolutions in real wages and real private consumption (figures in per cent) 2006 to 2016



Source: Destatis, Coface.

Increases in real wages, which have shown a marked rise since 2014, have been making a major contribution to the lively economy. As in 2015, real wages rose by around 2.5 % during the first half of 2016. Not only were wages higher in nominal terms – but also due to the stepwise introduction of statutory minimum wages. The rise in wages is partially linked to the improved negotiating position of trade unions and employees, due to the continuously improving situation on the labour market. In some sectors, such as social services, the craft sectors and engineering, there are even shortages of skilled labour.

In addition to increases in nominal wages, falling inflation has also contributed to the strong growth in real wages. Consumer price inflation slowed down from around 2.0 % in 2012, to reach just 0.3 % in 2015 – mainly due to reductions in energy costs. Inflation will only show a slight increase this year.

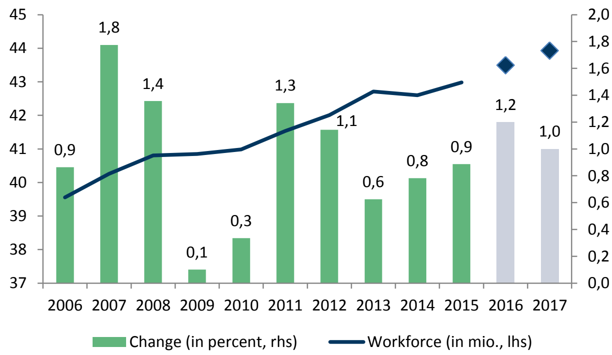
In 2017, however, the inflation rate is expected to climb sharply, to exceed the threshold of 1 % for the first time since 2013. In their joint forecast, the leading economic research institutes anticipate price increases of 1.4 %. The reasons for this are the unfavourable base effects of energy prices and the passing on of higher labour costs to the end consumer in the form of higher prices. The continuation of strong consumer spending in Germany provides companies with further options for passing on these costs.

With these rising inflation rates, the increase in real wages should show a clear slow down, to reach 1 to 1.5 % in the coming year. No further dampening effects on the development of real wages are expected. Minimum wages will be increased by around 4 % at the turn of the year - to the benefit of 2 to 3 million employees. Moreover, wage increases, comparable to those of the current year, are expected to result from the upcoming round of collective bargaining.

… but employment growth will retain much of its dynamism

Despite the slight slowdown, real wages will continue to increase in the coming year, further opening up potential for private household spending. A stronger driving force, however, is the continuing growth of employment in Germany, which – according to the joint diagnosis – is expected to rise from 0.9 to 1.2 %. This should provide an additional boost for private consumption in the following quarters.

Chart 10:
Number of people in employment (in millions) and change in per cent 2006 to 2017



Source: Destatis, Coface. Joint forecast, Coface. 2016 and 2017. Joint Forecast and Coface forecast.

Only a slight slowdown of the upward trend in employment is expected for 2017. This is supported by the Federal Labour Agency's job index, which continues to report all-time highs. This index is one of the major indicators of the demand for labour. According to the Federal Labour Agency, demands for labour are particularly strong in the trade, health and social services sectors. The Federal Labour Agency is also reporting increasing demand for the manufacturing sectors, business services providers and temporary employment agencies.

All of this signals anything but a reverse trend on Germany's labour market. Taking into account seasonal adjustments, in 2017, the number of employees could thus hit the 44 million milestone for the first time. This is a key factor supporting the country's sustainable growth in consumption.

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