The German economy

Macroeconomic situation

German economy still navigating choppy waters

The German economy is still navigating through choppy waters. Economic output declined slightly in the third quarter of 2023. According to the Federal Statistical Office's flash estimate, real gross domestic product (GDP) was a seasonally adjusted 0.1% lower than in the previous quarter, during which it had increased somewhat according to revised data.[1] Industry also suffered in the third quarter from weak foreign demand and the fallout from the prior energy price shock. Increased financing costs continued to dampen private investment, thereby also weighing on domestic demand for industrial goods and, in particular, construction work. Furthermore, order backlogs decreased further, absorbing less and less of the decline in demand in both sectors. As a result, output in these areas contracted. Real exports of goods also fell. Moreover, private consumption remained sluggish. Despite strong wage increases, declining inflation rates and stable employment, consumers still held back on additional spending. The services sector, by contrast, proved to be quite robust in this difficult environment.

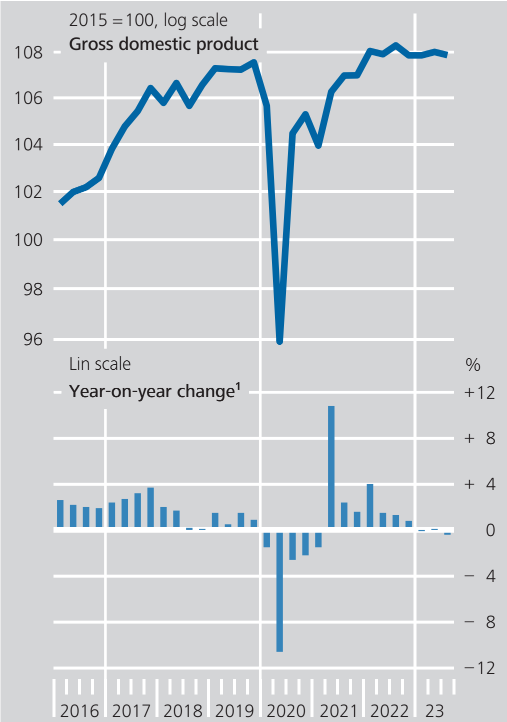
Economic activity in detail

Steep decline in industrial output and goods exports

Seasonally adjusted industrial output declined steeply in the third quarter, with the downturn broadly based. Even sectors that had bolstered activity in previous quarters, such as the manufacture of information processing equipment and, in particular, motor vehicle production, experienced a substantial slump. Output in the energy-intensive sectors ceased its downward movement, instead moving sideways. The weak domestic and foreign demand for industrial products has thus also become more evident in production levels overall. One factor behind this was likely that order backlogs were being steadily reduced and acting as less and less of a buffer. According to the ifo Institute, the share of industrial firms complaining of insufficient demand continued to grow significantly and recently stood at 36%. Supply-side problems, particularly bottlenecks in the supply of intermediate goods, have faded much more into the background, however. Persistently weak foreign demand and the impact of the preceding energy price shock, which hit Germany especially hard due, inter alia, to the high weight of energy-intensive sectors, are proving challenging for the export-oriented industrial sector, in particular. Price-adjusted exports of

Aggregate output

Adjusted for price, seasonal and calendar effects



Source of unadjusted figures: Federal Statistical Office. **1** Price and calendar adjusted.

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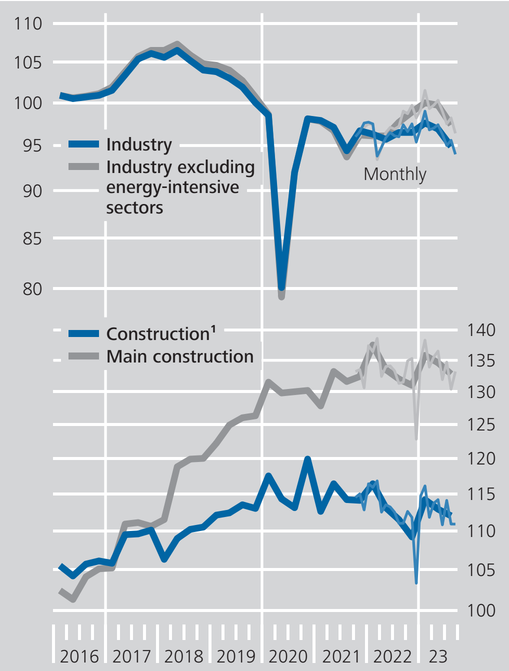
1 Seasonal adjustment here and in the remainder of this text also includes adjustment for calendar variations, provided they can be verified and quantified. The flash estimate also included revisions for the previous quarters in some cases. Overall, this results in a somewhat higher level of economic activity than previously reported.

Output in industry and in construction

2015 = 100, seasonally and calendar adjusted, quarterly data, log scale



Source of unadjusted figures: Federal Statistical Office. **1** Main construction sector and finishing trades.
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goods declined at a similar rate to industrial output in the third quarter.

Commercial investment in machinery and equipment probably down somewhat

Commercial investment in machinery and equipment is likely to have fallen somewhat in the third quarter. Weak industrial activity and higher financing costs made firms more reluctant to invest, as indicated by price-adjusted imports of capital goods as well as by price-adjusted domestic sales of capital goods, both of which declined. Investment in motor vehicles and machinery continued to have a bolstering effect here. Price-adjusted domestic sales in these areas picked up markedly. This is also consistent with the strong increase in commercial vehicle registrations according to the German Association of the Automotive Industry (VDA). However, this was driven by anticipatory effects relating to commercial electric cars ahead of the reduced government subsidy as from September.[2]

Increased financing costs and high construction prices driving down construction investment and output

Construction investment is also likely to have declined in the third quarter. In any case, construction output fell somewhat in seasonally adjusted terms. Output remained virtually unchanged in the finishing trades, but saw a sharp contraction in the main construction sector, primarily in building construction. The strongly depressed demand for construction work owing to increased financing costs and high construction prices is having a growing impact here. As measured by order intake in the main construction sector, this demand did increase on average over July and August (the latest months for which data are available) but, even so, it remained at a low level, especially in housing construction. There is still no improvement in sight in this segment, either, as the number of building permits fell sharply up until last report. The remaining backlog of orders prevented an even stronger decline in construction output. According to ifo Institute surveys, the reach of order books is still high overall, but more and more construction firms were complaining of a lack of orders. Order cancellations also rose to levels not seen for a long while.

Private consumption still sluggish, but services sector fairly robust

Private consumption probably remained sluggish in the third quarter. Despite rising real wages, households' mood for spending remained subdued and they were reluctant to make purchases. Price-adjusted sales fell in almost all areas of the retail sector. They were also down in the accommodation and food services sector. Moreover, current account figures for travel indicate that consumers cut back somewhat on their travel expenditure. By contrast, car purchases supported private consumption. According to data from the German Association of the Automotive Industry, new private car registrations saw a marked uptick, unlike motor vehicle production. The services sector proved to be fairly robust in this difficult environment. Even though the ifo Institute reports that assessments of the current situation

2 See German Association of the Automotive Industry (2023).

are deteriorating, when averaged over July and August output in the services sectors (excluding trade) was up distinctly on the previous quarter. Motor vehicle trade benefited not only from the increase in private registrations, but also from the high number of commercial registrations. By contrast, wholesale trade (excluding motor vehicles), which is more closely linked to developments in industry, was struggling with a decline in sales.

Labour market

Labour market stable

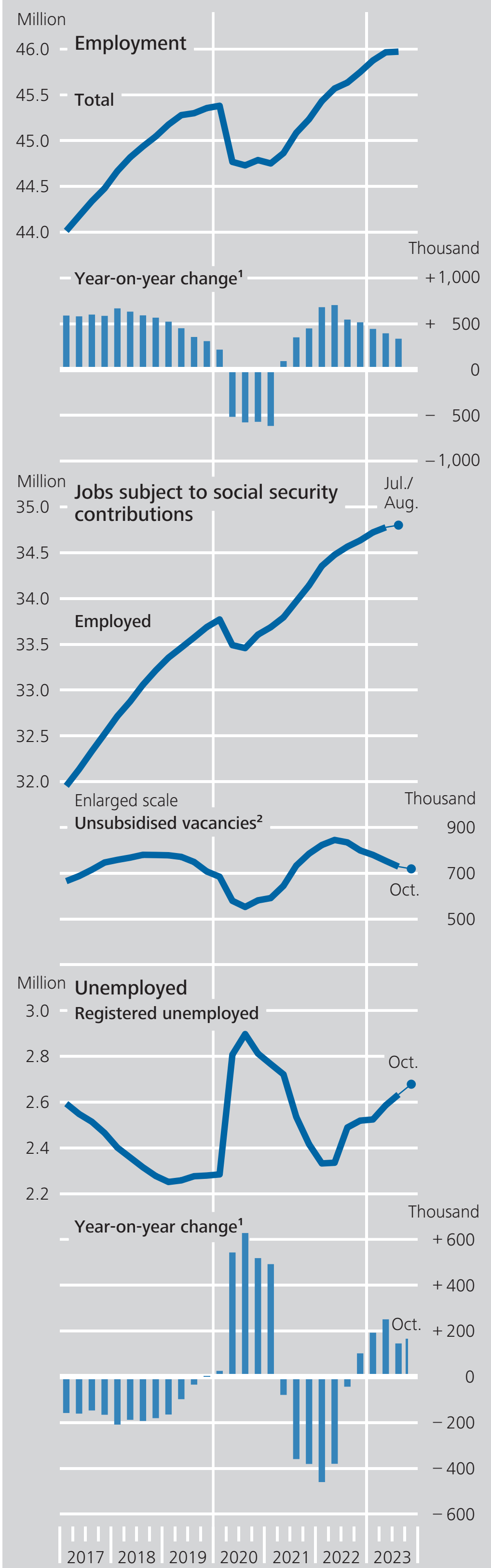
The robust labour market continued to stabilise economic activity in Germany. Despite the slight decline in economic output, employment in the third quarter remained at the high level recorded in the previous quarter, having risen strongly in the first half of the year. Unemployment was up moderately in the third quarter, but somewhat more sharply in October. The number of vacancies declined slightly, but remained at a high level. This means that the still very tight labour market – expressed by the ratio of vacancies to unemployed persons – eased only slightly. The employment outlook did not deteriorate any further in October and remained stable, meaning that no notable decrease in employment is expected in the fourth quarter, either.

Employment growth in some services sectors offsetting decline in manufacturing and trade

Given the tension between the current weak economy and a structurally very tight labour market, employment barely increased in Germany in the third quarter. Averaged over the reporting quarter, seasonally adjusted total employment was up by just 8,000 persons (+0.0%) from the previous quarter's level. The most important forms of employment – self-employment, low-paid part-time employment and employment subject to social security contributions – were more or less stagnant. For employment subject to social security contributions, the Federal Employment Agency's initial sectoral estimates are available up to August. They show that adverse cyclical factors were predominant in temporary employment, manu-

Labour market

Seasonally adjusted, quarterly data



Sources of unadjusted figures: Federal Statistical Office and Federal Employment Agency. **1** Not seasonally adjusted. **2** Excluding seasonal jobs.

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facturing, construction and trade, each of which saw a slight drop in employment. However, growth in services sectors which are barely affected by cyclical factors or are benefiting from structural change completely made up for this. These include, in particular, human health and social work, the public sector, education and training, as well as the IT sector and qualified business services. The number of employees in short-time work for economic reasons initially saw a distinct decline in the third quarter. This was mainly because the last remaining arrangements for easier access to short-time work during the pandemic expired at the end of June. The latest data on new registrations point to a moderate increase in short-time work over the coming months, however.

Further slight uptick in unemployment

Registered unemployment saw a further slight uptick in the third quarter. Looking at the quarterly average, the Federal Employment Agency recorded around 47,000 more persons as unemployed compared with the previous quarter in seasonally adjusted terms. The unemployment rate climbed by 0.1 percentage point to 5.7%. In October, unemployment rose significantly to 2.68 million persons, pushing the unemployment rate up to 5.8%. The year-on-year increase of around 165,000 persons is likely to be explained by cyclical factors for the most part. The cyclical weakness that has persisted for just over a year now is chiefly reflected in the higher unemployment among those receiving insurance benefits under the statutory unemployment insurance scheme, which has gone up by 97,000 persons. However, some of the increase is still attributable to the gradual integration of numerous immigrants into the labour market. This is primarily apparent in the higher level of unemployment among recipients of citizens' basic income.

Immigration paramount to labour supply

Employment and unemployment have risen in tandem in the preceding quarters. This is because of an expansion in the labour force. Major immigration in the past few quarters – from Ukraine in 2022, for example – is currently increasing the domestic supply of labour, which is in fact shrinking due to demographic factors. According to the Federal Employment Agency, the labour force[3] grew by more than half a million persons (+566,000) year on year up to April 2023, the latest month for which data are available. The number of Germans in the labour force decreased by around 82,000. By contrast, in arithmetical terms almost 650,000 non-German nationals were additionally integrated into the labour market in some form within the space of 12 months. The number of unemployed foreign nationals grew by around 250,000 in the same period, but the number of those in work actually went up by 400,000. The latter almost exclusively took jobs subject to social security contributions. Given the large proportion of refugees among recent immigrants and the particular challenges in labour market integration associated with this, this snapshot is proof of the high demand on the German labour market. In addition, there are immigrants who are undertaking preparatory measures such as integration and language courses or labour market policy measures but are not yet counted among the labour force.

Leading indicators suggest continuation of current stable labour market developments

Leading indicators of employment suggest that the current stable developments are set to continue over the next few months. According to the ifo Institute's employment barometer, recruitment plans for the next three months in trade and industry were marginally improved in October, but still point to a slight decline in employment. The equivalent barometer of the Institute for Employment Research (IAB) – which covers all economic sectors – remained virtually unchanged in slightly positive territory. The Federal Employment Agency's job index was also unchanged at last report. The number of

3 To differentiate by nationality, the limited reference figure of employed persons in the Federal Employment Agency's statistics is used, which includes only workers subject to social security contributions and low-paid part-time employees as well as the unemployed. In particular, self-employed persons and civil servants cannot be included in this figure. The statistics also have a relatively long time lag of six months.

vacancies barely decreased in October following the declines of previous months. The number of jobs available remains high. Nonetheless, unemployment is likely to go up again in the coming months according to the unemployment survey conducted by the Institute for Employment Research.

Wages and prices

Negotiated wages up sharply in Q3; even stronger rise in actual earnings

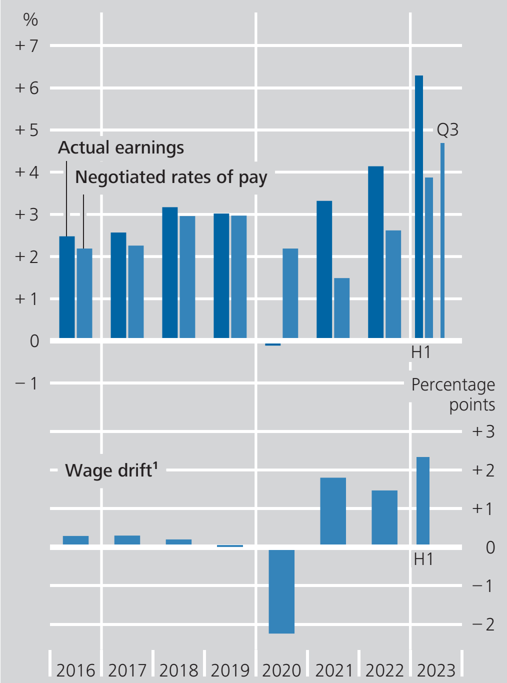
Negotiated wages were up even more sharply in the third quarter of 2023 than in the second quarter. Including additional benefits, they increased by a robust 4.7% on the year in the third quarter, compared with 3.9% in the prior quarter. As in the first two quarters of this year, large social contribution-exempt inflation compensation bonuses played a key role.[4] However, even excluding these bonus payments, negotiated wages rose by 3.0% on the year in the third quarter, representing markedly stronger growth than in the second quarter (2.5%). This shows that the permanent wage increases negotiated in the more recent wage agreements were also higher than those in the old agreements concluded before the current period of high inflation. These more recent agreements are becoming increasingly important. Actual earnings, in turn, are likely to have seen a significantly stronger rise than negotiated wages in the third quarter of 2023.

Wage agreements deliver large pay rises again; still no deal struck for trade

The most recent wage agreements again contained large pay rises for the most part. For example, the pay settlement agreed between Deutsche Bahn and the German Railway and Transport Union comprises a wage increase of 7.6% over a term of 12 months. Negotiations in the retail sector as well as in wholesale and foreign trade, which were launched back in April, have still not been concluded, nor is it likely that the wage dispute will be resolved in a timely manner. Therefore, at the recommendation of the German Retail Federation, several retailers took advance action to voluntarily raise their scheduled rates of pay by 5.3% from 1 October 2023. This is considerably lower than trade union ver.di's wage demands of 16% over a 12-month term. In the wholesale sector, employers offered permanent wage increases of 5.1% after four months with a pay freeze, which is also far removed from the 13% wage rise being demanded.

Rates of pay and wage drift

Year-on-year change, on monthly basis



Sources: Federal Statistical Office (actual earnings) and Deutsche Bundesbank (negotiated rates of pay). **1** Wage drift is calculated as the annual change in the ratio of actual earnings to negotiated rates of pay.

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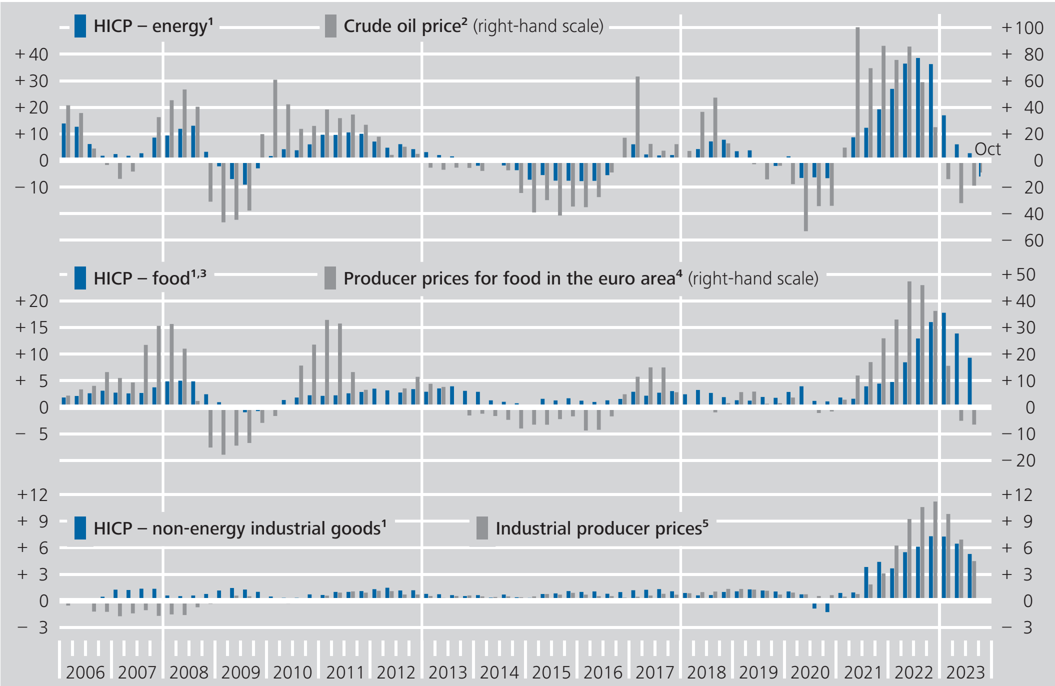
Wage demands remain high

By historical standards, the trade unions also made high wage demands for the other sectors that were in negotiations in the fourth quarter: a 10.5% wage increase over a 12-month term, but at least €500 per month, in state government, and a rise of 8.5% plus a social component in the wood and plastics processing industry. In the iron and steel industry, the IG Metall trade union is likewise calling for a wage increase of 8.5% over a 12-month term

4 The timing of inflation compensation bonus payouts varied in the third quarter: for example, according to the Bundesbank's negotiated pay rate statistics, a large one-off inflation compensation bonus was paid in the automobile trade and service sector in July, while monthly bonus payments have been made in central and local government since July.

Price developments at economic stages as classified for HICP purposes

Year-on-year percentage change



1 Eurostat. **2** Bundesbank calculations (in euro) based on daily prices in USD as quoted by Bloomberg Finance L.P. **3** Including beverages and tobacco products. **4** ECB calculations of DG AGRI prices based on the European Commission's farm-gate and wholesale market prices. **5** Analogous to HICP classification "non-energy industrial goods"; Bundesbank calculations based on data from the Federal Statistical Office.

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and, in addition, a reduction in collectively agreed weekly working hours from 35 to 32 hours with no cut in pay. Corporate profits also continued to increase, however. According to the profit margin indicator, which corresponds to the ratio of the gross value added deflator to unit labour costs, profit margins in the second quarter – the most recent quarter for which figures are available – rose by a seasonally adjusted 1.1% on the year. In an environment of gradually declining price dynamics, profit margins should also normalise over time.

Inflation rate down markedly in Q3 2023, partly due to base effects

Consumer prices as measured by the Harmonised Index of Consumer Prices (HICP) rose somewhat more slowly in the third quarter of 2023 than in the previous quarter. Averaged over July to September 2023, they increased by a seasonally adjusted 0.8% (second quarter: 1.0%). In particular, the rise in food and non-energy industrial goods prices was not as large as in previous quarters. This tallies with developments in commodity prices and at the upstream stages of production. By contrast, the steep upward pressure on prices in services continued virtually unabated. Energy prices even rose significantly again in the third quarter after falling in the previous two quarters. Nevertheless, looking at the year-on-year figures, the inflation rate continued to decline markedly in the third quarter of 2023, dropping from 6.9% to 5.7%. The sharp rise in energy prices in the third quarter of 2022 had a dampening effect here.[5] By contrast, the core rate (excluding energy and food) actually edged upwards slightly, climbing 0.2 percentage point to 5.8%, although this was due to one-off effects. Even additionally excluding the volatile components of clothing and travel services, the inflation rate was at a high level (5.5%).

5 This dampening base effect even compensated for the one-off effect driving services inflation, which rose again on the year. It is related to the €9 local public transport ticket introduced as part of a temporary relief package last year. Like the fuel tax rebate, this had pushed the inflation rate down considerably from June to August 2022 and expired at the start of September 2022.

Continued significant drop in inflation rate in October; core rate persistently high and above headline inflation

In October, consumer prices fell by a seasonally adjusted 0.2% on the month, having risen by 0.3% in September. This is mainly due to lower energy prices. However, food and services inflation also eased. The inflation rate saw another significant year-on-year drop, decreasing from 4.3% to 3.0%.[6] In October, too, the energy price-related base effect had a dampening impact. As a result, the core rate (excluding energy and food) decreased less sharply, from 4.8% to 4.2%. However, it remains far above the historical average and exceeds headline inflation.

Inflation likely to fluctuate around its present value in coming months

The inflation rate is likely to fluctuate sideways in the coming months. In the case of food and other goods, declining price pressures along supply chains and exerted by commodity prices will probably further dampen inflation. By contrast, the comparatively high upward pressure on prices in the services sector is expected to continue for a while, partly in the context of strong wage growth. In addition, the contribution of the energy component is likely to become positive again over the coming months as the dampening base effects disappear and the carbon price charged on fossil fuels is raised at the turn of the year. In December, there will also be a significant price-driving effect as a result of the price-lowering Act on Emergency Aid for Natural Gas Heating for End Consumers *(Erdgas-Wärme-Soforthilfegesetz)* adopted at the end of 2022. From the current perspective, inflation could therefore temporarily rise above 4% again.

Orders received and outlook

Economic output likely to decline slightly again in Q4 2023, but could then pick up somewhat in Q1 2024

The German economy is set to recover only arduously from the period of weakness that has persisted since the outbreak of Russia's war of aggression against Ukraine. Economic output is likely to once again decline slightly in the fourth quarter of 2023. However, it could then go back up somewhat in the first quarter of 2024. Domestic economic activity is expected to gradually start picking up speed, as households' real net income is anticipated to rise further on the back of large wage rises and easing price pressures. Even if households hold back on spending for a while longer, it is likely that they will therefore gradually consume more again in real terms. Industry is still operating under adverse conditions. Weak foreign demand and the fallout from the earlier energy price shock are continuing to curb its output. In addition, the boosting effects of drawing down existing order books are likely to diminish further. Yet tentative signs of a slight improvement after the turn of the year are beginning to emerge. For instance, the underlying trend in new orders suggests that foreign demand may have bottomed out. In addition, enterprises' business expectations for the next six months as surveyed by the ifo Institute have recently brightened, albeit only slightly. In the construction sector, however, there is no short-term improvement on the horizon yet. The rise in financing and construction costs is continuing to weigh heavily on demand for construction services, and output is expected to decline. Although the reach of order backlogs is still at a high level, it is declining rapidly. As a result, order backlogs are becoming less and less of a cushion against depressed demand and the many cancellations, especially in housing construction.

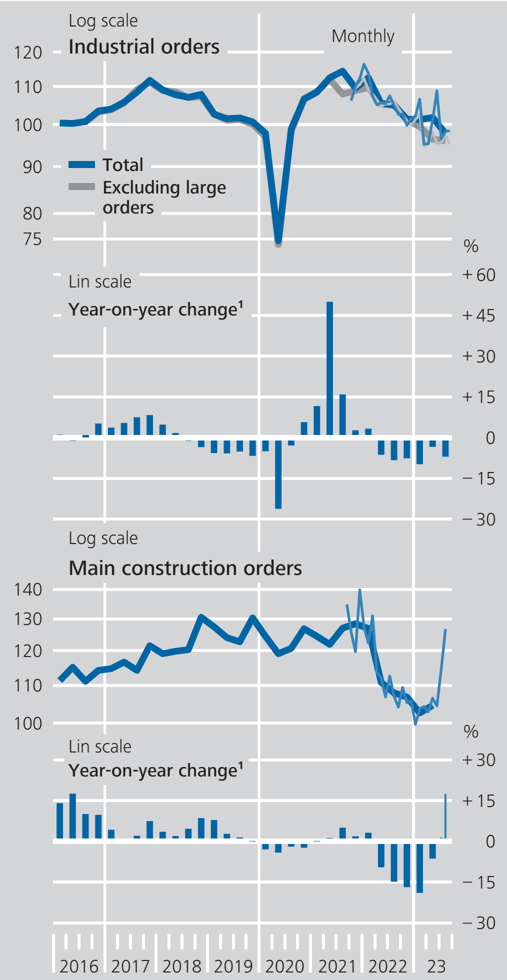
Industry still in weak phase, but tentative signs of slight improvement after turn of year beginning to emerge

Industrial output is likely to dampen macroeconomic developments again in the fourth quarter of 2023. Motor vehicle production could provide a boost, as indicated by higher production figures for October according to the German Association of the Automotive Industry. Overall, however, demand for industrial goods remained weak until recently. New orders in the third quarter of 2023 fell sharply on the quarter. However, this was mainly due to a lack of large orders. Even excluding large orders, there was still a decline, but its pace was mark-

6 The rate according to the national consumer price index (CPI) was 3.8%, down from 4.5%. As the share of energy in the CPI is significantly lower than in the policy-relevant HICP, the sharp decline in energy prices was less heavily pronounced in the CPI.

Demand for industrial goods and construction services

Volumes, 2015 = 100, seasonally and calendar adjusted, quarterly data



Source of unadjusted figures: Federal Statistical Office. **1** Only calendar adjusted.
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edly slower. New orders from abroad excluding large orders remained virtually unchanged, and those received from outside the euro area even rose slightly. In terms of the underlying trend, this may mean that foreign demand has bottomed out. This is consistent with the fact that ifo export expectations for the manufacturing sector for the next three months have stabilised, albeit at a low level. Moreover, according to ifo Institute surveys, industrial firms were slightly less pessimistic in October with regard to the expected business situation over the next six months. However, they scaled back their short-term production plans once again. So, all in all, tentative signs of a slight improvement after the turn of the year are beginning to emerge.

Private consumption should gradually benefit from rising real wages

The underlying trend in private consumption is likely to be pointing upwards in the current winter half-year. The labour market is proving broadly resilient to the slowdown in economic activity, wages are rising steeply and the inflation rate is declining. However, it is likely that households are still not yet dedicating all of their rising real income to higher consumer spending. This is because consumer sentiment remains poor. The consumer climate index forecast by the market research institute GfK for November deteriorated further. On the other hand, motor vehicle purchases will probably contribute positively to consumption, as has recently been the case. According to the German Association of the Automotive Industry, private car registrations rose again in October. Surveys by the ifo Institute for consumption-related service providers also indicate that households are gradually becoming more willing to spend. Business expectations in the retail sector have thus improved in recent months.

List of references

German Association of the Automotive industry (2023), Car production in Germany is weakening, press release of 5 October 2023, available at https://www.vda.de/en/press/press-releases/2023/231005_PM_Market-Data-Germany