The current economic situation in Germany

Overview

Strong economic recovery in second quarter

Global economic upturn strengthened

The global economic recovery gained momentum in the second quarter of 2021. Growth picked up mainly in the advanced economies which made progress in combating the pandemic. As vaccination campaigns progressed, many European countries eased containment measures that had been tightened in the last quarter of 2020 and first quarter of 2021. In the United States, real gross domestic product (GDP) grew fairly substantially, boosted by the economic stimulus package from March. The Chinese economy continued to pick up, despite a slowdown in the export boom. Meanwhile, the pandemic is maintaining its grip on other regions of the world. Fresh outbreaks in a number of emerging market economies set the stage for economic declines. Even in countries with relatively successful vaccination campaigns, there are risks to normalising social life, as the past few weeks have shown. Owing to the rapid spread of the Delta variant of the coronavirus, renewed restrictions and setbacks in the recovery process cannot be ruled out for advanced economies either. These will probably be less extensive, however, in view of the progress made on vaccinations. It is therefore important to push ahead with vaccination campaigns in order to contain new waves and limit their economic fallout.

Recovery in high-contact services a major factor

Providers of high-contact services, in particular, benefited from the reopening measures of the past few months. There was brisk demand for reopened food and beverage services. Signs pointed to a recovery in the travel sector as well. Global industry took a blow, however. This seems to have been because demand for certain goods, which had risen sharply during the pandemic, began to normalise. Additionally, there was a tightening of bottlenecks in the supply of various intermediate goods, particularly semiconductor components, which had already existed for some time.

Stronger inflation

Industrial producer prices continued to rise in many places given the bottlenecks in a number of industrial and supply sectors. This was partly down to the dramatic increase in transport costs, which continued apace in container shipping at least. The situation similarly remained strained in the commodity markets. Consumer price inflation also picked up considerably in many parts of the world. In the advanced economies, this was largely due to the reopening of services sectors which had previously been closed due to the pandemic; this was accompanied by a normalisation of prices in some cases and additional price rises in others. However, there are some signs that consumer price inflation will abate again in several months' time. Once the restrictions on economic life are largely rolled back, the price effects of reopening should fade out, and base effects owing to depressed prices at the trough of the crisis will gradually dissipate. The extent to which the strong rise in producer prices over the past few months will be passed on to consumers is still unclear though. This will depend on how much added pressure is put on corporate margins by broader-based increases in costs and wages.

Financial markets caught between economic recovery and evolution of pandemic

International financial markets were caught between the economic recovery and current assessments of how the pandemic will evolve. At the start of the quarter, the prospect of pandemic-related restrictions being eased, plus progress on vaccinations and positive business cycle signals, initially boosted market participants' confidence. This led to rising government bond yields around the world. Since the end of June, however, this development has reversed in view of uncertainty about the economic repercussions of the increasing spread of the Delta variant. Confidence that the end of the pandemic might soon be in sight, which was widespread in the second quarter, flagged

again. As a result, yields dropped as against the end of March. In the international equity markets, falling discount factors, a good start to the reporting season for companies, and higher profit expectations among analysts led to price rises on both sides of the Atlantic. But here, too, the prevailing uncertainty about how the pandemic will evolve left its mark and was reflected in higher equity risk premia. Corporate bond yields in the euro area fell over the entire reporting period against the backdrop of the ongoing purchase programmes. Overall, capital market financing terms for euro area enterprises thus remained favourable. At the same time, the unexpectedly sharp rise in inflation drew the attention of participants in international financial markets. Market data, consistent with survey results, signalled temporarily high inflation rates up to the end of the year. Longer-term market expectations of inflation, meanwhile, moved towards the 2% mark on balance – from different directions – on both sides of the Atlantic. Inflation figures also played a key role in foreign exchange markets and influenced the expectations of market participants about future central bank policy in the specific currency areas. Compared with the euro area, the monetary policy outlook in the United States and United Kingdom shifted slightly towards a somewhat less accommodative stance. This strengthened the US dollar and pound sterling against the euro, which had previously benefited from the euro area's progress on vaccinations. On balance, however, price changes in the foreign exchange market remained within tight limits over the entire reporting period.

Monetary policy: continued higher pace of PEPP purchases in Q3

After its June monetary policy meeting, the Governing Council of the ECB stressed that, based on a joint assessment of financing conditions and the inflation outlook, it expects net purchases under the pandemic emergency purchase programme (PEPP) over the third quarter to continue to be conducted at a significantly higher pace than during the first months of the year. It confirmed this assessment at its July monetary policy meeting. Net asset purchases will continue with an unchanged total envelope of €1,850 billion until at least the end of March 2022 and, in any case, until the Governing Council judges that the coronavirus crisis phase is over. If favourable financing conditions can be maintained with smaller asset purchase flows overall, the envelope of €1,850 billion need not be used in full. Equally, the total envelope can also be increased if necessary.

ECB Governing Council completes strategy review and adjusts forward guidance on key interest rates

In July, the Governing Council of the ECB also adopted its new monetary policy strategy, which includes an adjusted symmetric inflation target of 2% over the medium term. In this context, symmetry means that negative and positive deviations of inflation from the target are equally undesirable to the Governing Council. At the subsequent monetary policy meeting in July, the Governing Council revised its forward guidance on interest rates in support of its new inflation target. It now expects the key ECB interest rates to remain at their present or lower levels until it sees inflation reaching 2% well ahead of the end of its projection horizon and durably for the rest of the projection horizon. It must also judge that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at 2% over the medium term. This may also imply a transitory period in which inflation is moderately above target, according to the Governing Council.

Monetary growth still driven by Eurosystem asset purchases, as enterprises' demand for loans subsides

The broad monetary aggregate M3 grew significantly in the second quarter of 2021 as well. However, compared with the high net inflows at the start of the pandemic, the momentum of the expansion tailed off distinctly. This meant that the normalisation of monetary growth already seen in the previous quarter continued. On the counterparts side, loans to non-banks in the euro area again made the largest contribution to monetary growth. The majority of this was securitised lending to general government, driven by the Eurosystem's ongoing asset purchases. However, notable impetus also came from loans to the private sector, almost exclusively for house purchase. Non-

financial corporations, by contrast, reduced their borrowing from banks on balance. One reason for this was that the strong economic recovery improved their income situation. There was also a partial shift in financing sources in favour of the capital market, as already seen in previous quarters. At the same time, the banks participating in the Bank Lending Survey (BLS) reported that they had not tightened their corporate credit standards in the second quarter, counter to their own previous expectations.

Fairly steep growth in German GDP in Q2

German GDP saw a fairly substantial recovery in the second quarter of 2021. According to the Federal Statistical Office's flash estimate, real GDP was 1.5% up on the quarter after seasonal adjustment. This did not entirely make up for the decline in the first quarter, however, and nor was the Bundesbank's June projection fully matched. The main reason for the increase in the second quarter is that measures to contain the pandemic were loosened considerably after the incidence of COVID-19 infections started falling sharply as of May. This benefited services sectors in particular, such as hotel and restaurant services and parts of the bricks-and-mortar retail sector. Industry, on the other hand, was unable to tap the healthy order books because bottlenecks in the supply of some intermediate goods tightened once again. Industrial output even dropped markedly. By contrast, the construction sector grew, although here, too, there were increasing reports of bottlenecks in the supply of various building materials. Overall, GDP still fell short of its pre-crisis level (of the fourth quarter of 2019) by almost 3½%.

Consumption up sharply, investment and exports throttled by supply bottlenecks

On the demand side, private consumption was the mainstay of the economic recovery in the second quarter. This reflects the fact that, as restrictions were loosened, it was possible again to take advantage of consumption opportunities that had previously been unavailable. Government consumption is also likely to have risen sharply in view of spending on COVID-19 testing and vaccination efforts. By contrast, supply bottlenecks made a more or less significant dent in investment and exports. Business investment in new machinery and equipment is unlikely to have seen a quarter-on-quarter increase, whilst exports (including exports of services) were probably also up only slightly despite the continued high level of demand from abroad.

Firms' financing needs down in net terms, demand for loans for house purchase still high

The lending business of banks in Germany was less dynamic than in previous quarters. This comparatively weak lending activity was attributable to a significant net reduction in loans to non-financial corporations. In particular, firms repaid short-term loans that they had taken out – in some cases for precautionary reasons – in previous quarters. In addition, the financing needs of those firms hit especially hard by the coronavirus pandemic were curbed by the provision of sizeable government grants. At the same time, banks further expanded their lending to households on the back of persistently high demand for loans for house purchase, which are attractive due to the low general level of interest rates. Furthermore, according to the banks participating in the BLS, credit standards for housing loans were eased for the first time since the outbreak of the coronavirus pandemic.

Labour market started to bounce back strongly towards end of Q2

The real economic recovery that got under way in the second quarter was initially reflected in the labour market by means of an uptick in hours worked. The main reason for this was that short-time working, which was highly prevalent in the first quarter due to the crisis, decreased. It was only towards the end of the quarter under review that employment began to see stronger growth and unemployment started to rapidly decline. Leading indicators suggest that that this favourable development will continue over the coming months.

Negotiated wage growth stronger in Q2 than in Q1; actual earnings growth possibly even stronger

At 2.2%, the year-on-year increase in negotiated wages was stronger than in the first three months of 2021. This was chiefly due to large special coronavirus payments being made in a number of sectors. However, there was once

again only moderate growth in basic pay in the second quarter. By contrast, actual earnings probably went up by more than negotiated wages due to a substantial reduction in short-time working and a corresponding increase in the number of hours worked per employed person. Wage negotiations have been under way for some time between Deutsche Bahn and train drivers' union GDL, in the retail sector, in wholesale and foreign trade, at public and private banks and in the main construction sector. Here, too, the wage demands brought to the table by unions have been lower than in previous years. Even so, the dispute between Deutsche Bahn and GDL culminated in nationwide strikes.

Consumer prices in Q2 see sharp quarter-on-quarter growth …

In the second quarter of 2021, consumer price inflation (HICP) increased markedly as a general trend. At 1% in seasonally adjusted terms, the inflation surge was not as strong as in the previous year. However, the reversal of the temporary VAT reduction and the newly introduced carbon prices as part of the climate package placed strong upward pressure on prices at the start of the year. Disregarding these effects, inflation rose in the second quarter. Prices went up in all major components of the HICP. In the case of prices for non-energy industrial goods, it appears that price increases at the earlier stages of the pricing chain, which were caused not only by robust demand but also by bottlenecks along supply chains, were passed on to consumers to a considerable and greater than expected extent. Another potential factor here is that, after reopening, businesses charged higher prices in an attempt to recoup some of the losses they incurred as a result of having to close due to the pandemic. This is also likely to have contributed to the likewise fairly sharp rise in services prices.

… and are also higher than last year

Annual inflation increased overall from 1.7% in the first quarter to 2.2% in the second – and this was in spite of a one-off statistical effect no longer pushing up inflation as it had in the first quarter. This effect resulted from the significant change made to the weight used for package holidays in the HICP basket at the turn of 2020-21. Taking the volatile components, i.e. energy, food, travel-related items and clothing, out of the equation, the rate stayed virtually constant at 1.5% on a quarterly average. However, it increased from 1.4% to 1.7% between April and June.

Inflation rose further in July due to VAT base effect

Inflation rose further in July. Annual inflation surged overall from 2.1% to 3.1%, as price levels in the same month of the previous year were down markedly due to the temporary reduction in VAT rates. However, this price-driving base effect was counteracted by the aforementioned one-off statistical effect. Annual inflation as measured by the national consumer price index (CPI), which is unaffected by the statistical effect, went from 2.3% to as high as 3.8% overall.

Very high inflation rates expected for a time at year-end

The reported rate of inflation will increase further as the year goes on. This is partly because the one-off statistical effect will gradually turn positive up to November before finally ceasing to apply in December. As things currently stand, inflation rates of between 4% and 5% are possible at the end of the year. Inflation is likely to stabilise again, to a marked extent, in early 2022.

Economic output set for strong expansion in Q3

Economic output in Germany is set for strong expansion in the third quarter, at a rate that will far surpass the growth recorded in the previous three months. The main reason for this is the considerable easing of containment measures from mid-May, which is having a stronger and, in particular, more prolonged impact in the current quarter than in the previous one. The main sectors to benefit from the loosening of restrictions are services sectors that were hit especially hard, such as hotel and restaurant services, travel services and parts of the bricks-and-mortar retail sector. In industry and the main construction sector, order books are well filled. There are initial signs that the supply bottlenecks for certain intermediate goods and commodities are at least not worsening as significantly as they were in the second quarter.

The infrastructure and production capacity destroyed in the areas affected by the flood disaster represent an additional, but from a macroeconomic perspective probably manageable, drag on the economy. All in all, it remains to be seen whether GDP will reach its pre-crisis level in the third quarter already or whether this will be a fourth quarter event. There is uncertainty surrounding the further economic impact of the pandemic. For example, the Delta variant and vaccination slowdown could result in tighter restrictions being reimposed. However, this could then be expected to weigh more heavily on the economy in the fourth quarter. In view of lower than expected growth in the first half of 2021, too, economic growth could, as things now stand, be slightly lower on average for the year than foreseen in the June projection.

Government finances continue to provide high level of support to economy in 2021

Government finances are continuing to provide a high level of support to the economy in 2021. However, the economic upturn will have a positive knock-on effect on government finances as the year progresses, and support measures will become less significant. In 2021 as a whole, the deficit is likely to grow further and exceed 5% of GDP (2020: 4.5%). It should be noted, though, that this will be driven largely by measures not connected to the coronavirus crisis, e.g. the partial abolition of the solidarity surcharge.

2022: assuming continued economic recovery and end of coronavirus aid, sharp decline in deficit to be expected

Assuming that the economic recovery continues, it will be possible to phase out coronavirus-related spending (such as government bridging aid to enterprises). Additionally, wage replacement benefits will play a smaller role, whilst inflows of taxes and social contributions will increase. In this respect, government finances will recover automatically. With that in mind, a sharp decline in the deficit in 2022 can be expected as things stand today. Provided the fiscal stance currently envisaged is not loosened, the deficit ratio could decrease to around 1½%.

EU fiscal rules in need of straightforward consolidation

In structural terms, the general government deficit could stand at a similar level. The deviation from the medium-term budgetary objective of 0.5% of GDP under EU rules would therefore not be too significant, even compared with previous years. There is therefore no need for Germany to pursue an overly ambitious fiscal policy in the next legislative period. In particular, the process of structural consolidation can take place gradually and, based on current expectations, in a favourable economic setting.

Federal budget spending probably significantly lower than envisaged this year, too

The Federal Government has been assuming the lion's share of the costs of the coronavirus crisis. A large Federal deficit can be therefore expected for this year, too. However, coronavirus-related spending is likely to be significantly lower than budgeted for. This is unlikely to be anywhere near offset by additional expenditure in connection with the floods in July 2021. All in all, as things currently stand, the Federal Government's net borrowing will be far lower than planned in the supplementary budget (€240 billion). It may even remain under the €180 billion allocated in the original budget.

Fiscal rules not at odds with prudent measures, but prioritisation required

The 2022 Federal budget will be passed by the new Bundestag. By then, it should be possible to get a more reliable gauge of the economic developments and budgetary burdens stemming from the pandemic in the year to come. From the present perspective, there will be no reason to activate the escape clause again. Use can be made of the sizeable reserves. Furthermore, there is much to suggest that the clause will no longer be needed next year to address the coronavirus crisis. Under the debt brake, spending deemed sensible, or simply necessary, may be funded and expanded – in connection with climate change or digital transformation, for instance. However, its objective is to keep revenue and expenditure in a pre-agreed state of balance. What this ultimately means for the Federal Government and the Bundestag is that they need to clearly and transparently convey to the public which areas of spending have priority and, if necessary, why taxes need to be raised.