The current economic situation in Germany

Overview

War and supply bottlenecks weighing on economic recovery and driving inflation

War against Ukraine and anti-coronavirus measures in China straining the global economy

The consequences of Russia's war of aggression against Ukraine, which began at the end of February 2022, are weighing on the global economy. Activity is being throttled in particular by the surge in the prices of numerous commodities, which is driving up enterprises' production costs and diminishing households' purchasing power. Heightened uncertainty about the availability of key raw materials and intermediate inputs is adding to the gloom surrounding the business climate. This is affecting a number of European countries in particular that are heavily dependent on Russian energy supplies. March also saw the disruptions to international supply chains flare up again, after having previously faded into the background somewhat. Given the strict measures introduced in China to combat the spread of the coronavirus, these problems could become considerably more acute in the near future.

Perceptible rise in commodity prices since the start of the war …

Following the start of the war, the prices of fossil fuels as well as some industrial metals and food, of which Russia and Ukraine are among the world's most significant producers, increased abruptly. This was mainly on account of concerns about future supply stoppages and embargo measures. After it became clear that energy commodities would initially be largely exempt from western sanctions, and with Russian commodity exports falling only moderately to date, prices declined again sizeably for the most part. Food prices, however, especially those for wheat and corn, continued to rise until this report went to press.

… and, as a result, stronger consumer price inflation

In combination with the strong price pressures at upstream stages of production, the high energy and food prices played a major role in the further considerable increase in consumer prices across the globe. In the industrial countries, annual consumer price inflation reached 7.6% in April, its highest level in more than 40 years. The narrower core definition of inflation, excluding energy and food, continued to climb as well, reaching 5.0%. In view of persistently high prices for commodities, transport services and other intermediate goods, consumer prices are likely to keep rising sharply in the coming months.

Financial markets concerned over rising inflation rates and war against Ukraine

Financial market developments influenced by rising inflation rates, war against Ukraine and less accommodative monetary policy

Mounting inflation concerns and the war against Ukraine also shaped developments in global financial markets in recent weeks. Given higher inflation rates and expectations, bond market yields rose markedly worldwide, also against the backdrop of key central banks pushing to recalibrate monetary policy. For example, the UK and US central banks further tightened their monetary policy stance by repeatedly raising their policy rates. In addition, the Federal Reserve announced that, starting in June 2022, it would reduce its holdings of assets purchased under monetary policy purchase programmes. The Bank of Japan, by contrast, pledged to stick to its policy of keeping yields low. The war against Ukraine added to the inflation concerns that had already been worrying market participants, not least on account of the considerably higher energy prices; the conflict ultimately also stoked expectations of a faster adjustment of the monetary policy stance. Moreover, the war increased uncertainty surrounding the economic outlook. This culminated in growing financial market volatility and a sharp but brief slump in stock prices. Significantly stronger headwinds on the stock exchanges came from the higher interest rate level. Overall, European and US stocks have declined substantially in value in the year to date. In foreign exchange markets, the feared economic fallout from the war and expectations concerning differences in the pace of monetary policy adjustment in the major currency areas pushed down the euro's exchange rate.

Monetary policy: ECB Governing Council signals prospect of swifter normalisation

The end of the extremely expansionary monetary policy drew closer in the euro area, too. In March, the Governing Council of the ECB decided to scale back purchases under the asset purchase programme (APP) more rapidly over the course of the second quarter than had been planned in December. April saw the ECB Governing Council conclude that the net purchases could be discontinued in the third quarter. The ECB Governing Council also amended its forward guidance on policy rates. According to the new wording, the Governing Council will make any adjustments to the key ECB interest rates "some time" after the end of the net asset purchases under the APP. With this new wording, the Governing Council is maintaining optionality in terms of the timing of its first interest rate moves. This also includes the possibility of making the first increase in key interest rates very soon after the end of the net purchases under the APP. Recent statements by numerous members of the Governing Council have given a significant push to corresponding market expectations of a first interest rate hike, with markets currently anticipating the first move in July and pricing in four 25-basis-point increases by the end of the year.

Monetary growth flagging further

The broad monetary aggregate M3 grew significantly in the first quarter of 2022 as well. However, growth continued to lose momentum compared to the strong inflows of the preceding quarters. This was due to the reduction in net asset purchases under the pandemic emergency purchase programme (PEPP), which were discontinued in March, as planned. At the same time, lending to the domestic private sector continued to rise sharply in the first quarter, primarily in the form of loans to households for house purchase, but also as loans to non-financial corporations. The expectation of rising bank lending rates is likely to have been an important driver of the buoyant demand for credit. The banks responding to the Bank Lending Survey (BLS) reported that they had tightened credit standards for loans to enterprises again somewhat in the first quarter, for the first time in a year.

Strong recovery that would have been expected in the German economy from spring onwards significantly weakened

German economy weighed down by pandemic, high inflation and the Russian attack on Ukraine in Q1 2022

Economic activity in Germany picked up slightly in the first quarter of 2022, after declining somewhat in the final quarter of 2021. According to the Federal Statistical Office's flash estimate, real gross domestic product (GDP) was 0.2% up on the quarter after seasonal adjustment. Construction provided a strong boost, helped by the mild weather conditions. On the back of a good start to the year, industrial output also increased somewhat on the quarter. The effects of Russia's war on Ukraine have been weighing considerably on the economy since the start of the conflict, however. Supply bottlenecks flared up again in industry and construction, after having arguably eased somewhat at the beginning of the quarter. The sharp rise in energy prices, too, will have dampened output. Exports declined sharply in March and were also well below the previous quarter's level in the first quarter of 2022 as a whole. High energy prices also exacerbated the already high rate of price increase, diminishing the purchasing power of household incomes. This depressed private consumption, which was impaired further by the pandemic and the associated containment measures. By contrast, construction investment and investment in machinery and equipment are likely to have increased, despite the supply bottlenecks.

Robust uptick in German banks' loans to domestic private sector

This is also borne out by German banks' continued robust lending to households and non-financial corporations. Household demand for loans, especially those for house purchase, remained strong. In addition to their income and asset situation, which remains favourable, households' desire to lock in interest rates played a role here. Demand for loans was again high on the part of enterprises, too. The borrowed funds were used for the short-term bridging of unplanned financing needs for inventories and working capital and to fund fixed investment.

Employment and unemployment barely touched by strains on the economy

The German labour market developed exceptionally favourably in the first quarter of 2022. Employment expanded strongly and unemployment continued to decline markedly. In contrast to the number of hours worked per employee, which likely remains depressed, both indicators were back to where they had been just before the outbreak of the pandemic. However, this also saw the return of the labour shortages seen in pre-crisis times. The factors weighing on economic activity in the first quarter – the strong spread of the Omicron variant and, most recently, Russia's invasion of Ukraine – are more likely to have had an adverse impact on actual hours worked by employees and labour productivity. Short-time work for economic reasons increased again somewhat, for instance. Nevertheless, the leading labour market indicators remained optimistic for the coming months after having been briefly shaken by the outbreak of war.

Negotiated wages rose considerably in Q1 due to high one-off payments; actual earnings probably rose substantially as well

Negotiated wages recorded significantly stronger increases in the first quarter of 2022 than in the final quarter of 2021, rising by 4.4% on the year mainly as a result of high one-off payments and coronavirus bonuses. By contrast, after adjustment for such one-off payments, basic remuneration was up by only 1.6%. Actual earnings are likely to have risen even more steeply than negotiated wages in the first quarter, mainly on account of the marked decline in short-time work compared with the previous year.

At present, the growth in negotiated wages is still being influenced by existing collective agreements that had been concluded in a setting of lower inflation rates and pandemic-related challenges. New agreements made in the first quarter, too, were still moderate for the most part, despite the sharp rise in inflation. Upcoming wage negotiations could, on the one hand, see the uncertainty surrounding future economic growth and concerns about potential job losses dampening wage increases somewhat. On the other hand, the persistently high inflation rates and mounting labour market shortages will probably contribute to markedly more substantial wage settlements than in the recent past. It should be borne in mind here that the increased prices for largely imported fossil fuels narrow the scope for income distribution in Germany.

Wage agreements still moderate so far, but distinctly larger wage increases possible in coming months

Inflation picked up significantly in Q1 …

Consumer prices experienced another steep rise at the beginning of the year. In the first quarter of 2022, inflation as measured by the Harmonised Index of Consumer Prices (HICP) stood at 2.8% on the quarter after seasonal adjustment. This was the strongest quarterly increase in prices in Germany since the beginning of monetary union. Energy prices picked up at a particularly rapid pace. Moreover, food price inflation and the inflation rate for non-energy industrial goods grew considerably as a result of new supply bottlenecks. Looking at the year-on-year figures, the inflation rate rose significantly in the first quarter of 2022, from 5.4% to 6.1%. By comparison, core inflation excluding volatile energy and food components came to 3.1%. It was therefore lower than in the previous quarter, when the price-driving effect of the expiry of the VAT cut was still being recorded.

… and is likely to remain high for the time being

In April, prices after seasonal adjustment increased considerably on the month, albeit not at the exceptional pace seen in March. This was chiefly attributable to energy prices, which eased slightly following a sharp rise in the previous month. Compared with the previous year, headline inflation came to 7.8%, up from 7.6% in March. Similarly high rates were last observed in the former West Germany during the first Gulf War at the beginning of the 1980s.

Given this strong rate of upstream inflation, from today's perspective average inflation for the current year is expected to sit at around 7%. That said, uncertainty about the price outlook is particularly high at present.

Economic output likely to increase slightly in Q2 at best; boost produced by easing of coronavirus protection measures counterbalanced by impact of Ukraine war

As things stand today, German economic output is likely to increase slightly, if at all, in the second quarter of 2022. This is due to the interplay of strong but opposing forces. On the one hand, the easing of the measures to protect against the coronavirus is likely to provide a major boost to services sectors and the related consumer spending. On the other hand, the repercussions of Russia's attack on Ukraine are exacerbating the pressures exerted by high inflation and supply bottlenecks. They are also giving rise to further negative effects and will probably considerably weaken the strong recovery that had previously been anticipated. Household consumption will be dampened by the high level of inflation and by the uncertainty about how the conflict will evolve. High energy and material costs and the heightened uncertainty are also weighing on output in the industrial sector and in construction. Supply chains are once again coming under significant strain on account of the Ukraine war and COVID-19 lockdowns in China. Exports are also likely to remain markedly below the level of the first quarter due to disruptions in foreign trade and lower foreign demand as a result of the war's impact.

Outlook for public finances in the current year and in the medium term

Fiscal policy response to fallout from Russian war of aggression

Fiscal policy is currently responding to the fallout, in terms of defence, energy and social policy, from the Russian war of aggression. The Federal Government is planning to step up defence spending, for example. Other measures aim to shield households and enterprises to a degree from the steeply rising energy costs. Assistance packages for refugees and for Ukraine are another factor. The measures are to be financed by new borrowing, which is why it looks like deficits will be higher than anticipated as recently as the start of the year.

Significant decline in deficit anticipated nonetheless

Uncertainty is, once again, very high. From today's perspective, though, the general government deficit is likely to decline significantly in this year and the next (2021: deficit ratio 3.7%). This assumes that the fallout from the war remains limited and that the coronavirus crisis does not flare up again. In that scenario, the coronavirus response measures and the new temporary assistance will probably expire and the economy could be expected to recover.

Central government expected to see substantial structural deficits in the medium term

The coming years are likely to see substantial structural deficits, mainly on account of central government. Although the Federal Government announced that compliance with the debt brake would resume from 2023 onwards, it is planning to use the extensive general reserve, which will result in a correspondingly higher deficit. Additional extensive deficits are expected in the special funds. These will affect, in particular, the planned new special fund for the German armed forces and the Energy and Climate Fund (ECF). The additional leeway for deficits in the special funds as well as from the core budget reserves amounts to around €230 billion in total (currently 6% of GDP). That leeway is likely to be all but fully utilised up to 2026, meaning that the deficits could be almost 1½% of GDP higher between 2023 and 2026 than without that scope.

Broad leeway for deficits due to broad interpretation of the escape clause

Central government created the broad leeway for deficits from 2023 onwards partly out of emergency borrowing from 2020 and 2021, using this primarily to top up the ECF, for example. The resources will be used to fund climate change mitigation measures for some years. However, the Federal Constitutional Court is currently assessing whether emergency borrowing from 2021 can be rolled over. In the current year, additional emergency borrowing is also planned for measures relating to the Russian war against Ukraine. There would need to be good reasons why the individual measures are suited to overcoming the emergency situation. It would also have to be explained why, in the current economic setting, these need to be funded out of additional emergency borrowing (instead of counterfinancing them or using the reserve, which currently totals just under €50 billion).

Fiscal policy in a difficult economic environment

In a scenario of supply bottlenecks, credit-financed impulses produce smaller real effects and increased price pressures

Government budgets are a key anchor of stability in times of crisis. That said, there is no compelling case for a large credit-financed fiscal stimulus at the current juncture, particularly in view of the high price inflation and supply bottlenecks. In an economic situation such as this, additional credit-financed demand impulses have smaller real effects and tend to increase price pressures, if anything.

Let price signals take effect

The objectives of energy policy are to make Germany independent of Russian energy supplies as soon as possible and to achieve net zero carbon emissions over the long term. Price signals support these aims efficiently by indicating shortages and triggering important adjustment reactions. Government measures that reduce energy prices in the short term counteract the desired adjustment process, meanwhile.

Targeted support for households and firms without hindering transformation

In the current situation, low-income households need government protection. Means-tested measures such as the one-off payments for low earners can provide targeted relief here. The one-off energy price allowance will also benefit lower-income individuals to a greater degree. This allowance is a broader-based measure, however, given that all persons in employment will receive this amount, which is subject to taxation. Other parts of the since-adopted package of measures for households clash with the energy policy objectives to a degree. Targeted transfer, guarantee and loan programmes are planned for distressed enterprises. What is important is that these programmes preserve the incentive for enterprises to rapidly cut back their use of fossil fuels and to turn to renewable sources of energy.