Overview

Continued sharp rise in prices, clouded macroeconomic outlook

Global economy contracted in Q2 2022

A number of stress factors put the global economy under pressure in the second quarter of 2022. In China, the strict restrictions imposed to combat the pandemic considerably dampened economic activity. In the United States, aggregate output fell again somewhat against the backdrop of high inflation rates and continued monetary policy tightening. The persistently high level of consumer price inflation also weighed on private consumption in a large number of other countries. At the same time, sentiment deteriorated markedly around the world. The global economy is currently facing unusually high uncertainty.

Industrial activity: delivery times increasing only slightly, price pressures easing at upstream stages, but gas prices rising sharply

Although demand for services picked up again significantly across the globe after the extensive lifting of pandemic-related restrictions, this did not fully offset the weak demand for industrial goods. According to surveys of purchasing managers, weak demand was the main drag on global industry in the meantime. Disruptions caused by supply-side bottlenecks therefore also became less important. Accordingly, delivery times increased only slightly, and price pressures eased somewhat in industry. Many commodity prices, including crude oil prices, also fell markedly. By contrast, European gas prices rose sharply. This was mainly due to Russia's decision to deliver less gas to Europe via the Nord Stream 1 pipeline and concerns about a sweeping suspension of Russian deliveries.

Renewed rise in consumer price inflation, uncertain outlook

Consumer price inflation rose again worldwide. Annual consumer price inflation in the industrial countries increased to 8.3% by July. In the euro area, in particular, energy prices went up dramatically. Moreover, upward pressure on prices is now broadly based. In the narrow definition, excluding energy and food, the inflation rate remained at a high 5% in the industrial countries. Looking ahead, the rise in prices at the upstream stages should gradually moderate in the light of the slowdown in global economic activity and, in some cases, deteriorating commodity prices. However, the upside risks to inflation are high. Further price surges would be expected for energy, especially if Russian gas deliveries were to be suspended altogether. Moreover, owing to the tight labour market situation in some industrial countries, robust wage growth could lead to undesirable second-round effects.

High inflationary pressures driving rising yields in the capital markets

Financial markets influenced by high inflation rates and a clouded economic outlook

In the reporting period, the international financial markets were also influenced by increasing inflation rates and growing economic concerns. With inflation still surprisingly high in many economies, government bond yields rose significantly around the world until mid-June. Against this backdrop, market participants priced in an increasingly contractionary monetary policy stance by key central banks, amongst other things. The UK and US central banks tightened their monetary policy by repeatedly raising their policy rates: in August, the Bank of England carried out its sixth policy rate hike since December of last year to the new level of 1.75%, and the US Federal Reserve System increased its policy rate in June and July by 75 basis points, respectively, to a new target range of 2.25% to 2.5%. In addition, following on from the Bank of England, the Federal Reserve System also began to reduce the securities holdings it had acquired under monetary policy purchase programmes. By comparison, the Eurosystem adopted more of a wait-and-see approach, but with the end of net purchases under its asset purchase programme (APP) and a subsequent first key interest rate hike, it has now taken major steps in the process of mon-

etary policy normalisation. At the same time, however, economic concerns became more entrenched in the reporting period. In Europe, they were fuelled by restrictions on natural gas deliveries from Russia, amongst other things. From around mid-June, market participants gradually lowered their expectations of monetary policy tightening in the current cycle, which dampened the preceding increase in yields. In this environment, price developments in the equity markets remained negative, like in the first quarter. In addition to the net rise in risk-free interest rates, a decline in the medium-term earnings growth outlook had a dampening effect on equity prices. Monetary policy also played an important role in the foreign exchange markets. The brisker pace of US monetary policy normalisation, coupled with the Eurosystem's comparative wait-and-see stance, caused the euro to depreciate, especially against the US dollar. On top of this, a declining risk appetite among foreign exchange market participants weighed on the single currency relative to the US dollar.

ECB Governing Council takes significant monetary policy decisions

Monetary policy: ECB Governing Council ends net asset purchases under the APP, raises key interest rates and …

In June, the Governing Council of the ECB decided to end net purchases under the asset purchase programme (APP) as of 1 July 2022. In July, it decided on a first key interest rate hike of 50 basis points in the light of renewed upside surprises in price developments. At its upcoming meetings, further normalisation of interest rates will be appropriate in view of inflationary risks tilted to the upside.

… approves new Transmission Protection Instrument

Moreover, the Governing Council approved a new Transmission Protection Instrument (TPI) in July. Particularly while monetary policy is normalised, the TPI is intended to ensure that the monetary policy stance is transmitted smoothly across all euro area countries. Under the TPI, the Eurosystem is able to make secondary market purchases of securities issued in jurisdictions experiencing a deterioration in financing conditions not warranted by country-specific fundamentals. Any decision by the Governing Council to activate the TPI will be based on a comprehensive assessment of market and transmission indicators. In particular, the Governing Council will consider several criteria to assess whether the jurisdictions in which the Eurosystem may conduct purchases under the TPI pursue sound and sustainable fiscal and macroeconomic policies.

Monetary growth in the euro area flagging further

The scheduled reduction in net asset purchases also further weakened growth in the broad monetary aggregate M3. By contrast, loans to non-financial corporations and households in the euro area rose steeply. In the case of enterprises, it was especially the massive trade restrictions and the increased purchase prices that drove demand for credit. In this context, banks tightened their standards for loans to enterprises and housing loans significantly. They justified this on the grounds of a perceived increase in credit risk and a decrease in their risk tolerance.

German economic output stagnates: war in Ukraine and major purchasing power losses

German economic output stagnated in Q2 2022

Economic growth in Germany for the first quarter of 2022 was recently revised significantly upwards, to 0.8%. Economic output thus returned to roughly pre-pandemic levels. In the second quarter, however, seasonally adjusted real gross domestic product (GDP) stagnated compared with the previous quarter (according to the Federal Statistical Office's flash estimate). The economy was caught between opposing forces in the second quarter. Although the elimination of most coronavirus mitigation measures lent a strong boost to previously beleaguered service providers, surging prices and uncertainty associated with the war in Ukraine put pressure on households and enterprises. Industry was also confronted with weaker demand and the persistence of marked supply

bottlenecks. Shortages of materials weighed on the construction sector, too, on top of a lack of labour. Furthermore, construction activity had expanded sharply in the first quarter owing to favourable weather conditions, which was followed by a countermovement in the second quarter.

Private consumption and exports buoyed economy

On the demand side, the economy was buoyed mainly by private consumption in the second quarter. The elimination of coronavirus mitigation measures went hand in hand with a strong increase in consumer spending on services to which access had previously been restricted. Exports also provided a boost. Business investment in new machinery and equipment is likely to have risen only marginally owing to the high level of uncertainty and supply bottlenecks. Construction investment is likely to have fallen sharply, though.

Continued robust credit growth

Credit growth remained robust, however, with banks in Germany once again strongly expanding their lending to non-financial corporations and households in the second quarter. The funds borrowed by enterprises were mainly used to cover short-term financing needs for inventories and working capital. Securing bank lending rates, which were still relatively favourable compared with bond yields, also played a role. In addition, households' demand for loans for house purchase, in particular, remained elevated despite higher lending rates and significantly tighter credit standards and terms and conditions.

Economic strains destroying momentum of labour market catch-up

The labour market's rapid catch-up process lost considerable momentum following the lifting of pandemic restrictions. Nevertheless, employment continued to rise in the reporting quarter. Employers made use of short-time working to only a relatively small extent. Whilst unemployment increased considerably starting in early June 2022, this was due solely to the fact that Ukrainian refugees were included in Germany's social security system. Positive expectations regarding future developments were downgraded slightly.

Negotiated wages excluding bonus payments still up moderately in Q2

Negotiated wage growth in the second quarter of 2022 was weaker than in the preceding quarter, during which high bonus payments in industry and coronavirus bonuses temporarily caused the growth rate to soar. However, adjusting for these bonus payments, negotiated wages rose more sharply in the second quarter than in the first, climbing by 2.1%. Actual earnings are likely to have once again risen more strongly than negotiated wages in the second quarter, with growth being hardly any smaller than in the first quarter. This was due primarily to the significantly higher number of hours worked in a year-on-year comparison owing to the massive drop in short-time working in 2022.

Recent wage agreements contain higher rates

At present, growth in negotiated wages is still being driven by old collective agreements, which were concluded in an environment of lower inflation rates and pandemic-related challenges. That said, some new pay deals concluded in the second quarter, in which inflation had risen sharply, were slightly higher than previously. Despite this, they fell well short of the annual consumer inflation rate. The still high level of uncertainty, stemming first and foremost from the effects of the war in Ukraine, as well as the sometimes high cost burden on enterprises, stood in the way of higher pay deals. These dampening factors still apply, and the scope for pay increases is being narrowed by rising energy import prices. However, the ongoing loss of purchasing power due to high inflation is likely to play an increasingly important role in upcoming wage negotiations. Wage pressures are also likely to be higher than in the second quarter owing to growing labour market shortages.

Inflation rate likely to reach new highs in Q4

Inflation in Q2 still extremely dynamic

The exceptionally strong rise in seasonally adjusted harmonised consumer prices (HICP) continued into the second quarter, too. Energy prices went up as crude oil prices continued to

increase. This development obscured the temporary reduction in fuel taxes (fuel rebate). Furthermore, electricity and gas tariffs were again raised significantly in the second quarter. Prices for food and non-energy industrial goods were somewhat higher again than in the previous quarter. For the latter, rising commodity costs and supply bottlenecks are likely to have been the main factors playing a role. The cost of services continued to rise markedly up to May. In June, however, prices fell distinctly. This was due to the introduction of the €9 ticket for local public transport. Like the fuel rebate, it is part of the June relief package and is available for three months. In annual terms, average HICP inflation rose to 8.3% in the second quarter of 2022, while the rate excluding energy and food hit 3.7%.

New records for inflation rate likely in Q4

In July, prices surged again on the month in seasonally adjusted terms. Food prices, in particular, continued to rise very sharply. Energy prices did not fall, despite the renewable energy (EEG) levy being abolished and crude oil prices declining. This was offset mainly by higher gas prices. Overall, annual inflation climbed from 8.2% to 8.5%. Another marked rise in the inflation rate is expected once the measures contained in the relief package expire in September. The increase in the general statutory minimum wage and the depreciation of the euro will push it up further in the coming months. In addition, a levy on gas tariffs is set to be introduced in October and the VAT rate on gas reduced at the same time. In total, the inflation rate could reach a level of 10% in the fourth quarter. However, the inflation outlook remains extremely uncertain, especially due to the unclear situation on the commodity markets.

Declining economic output now much more likely in Q4 2022 and Q1 2023

Economic developments in Germany will be impaired in the third quarter and beyond by unfavourable developments in the gas market. According to the current assessment, German economic output in the third quarter is likely to stagnate again more or less. The high level of uncertainty surrounding the supply of gas over the coming winter and the sharp increases in prices are likely to place a considerable strain on households and enterprises. The market research institute GfK established that consumer sentiment is poor, and firms' business expectations fell to very low levels. According to ifo Institute surveys, supply bottlenecks in industry and construction are still a major problem. Moreover, the shortage of skilled workers reached an all-time high of late. In addition to supply-side strains, demand is flagging in industry and construction. By contrast, the elimination of coronavirus protection measures continues to provide positive stimuli for previously beleaguered service providers and related private consumption. In addition, the latest data suggest that industry and foreign trade have been able to withstand adverse factors until recently. However, the probability of GDP declining in the approaching fourth quarter of 2022 and the first quarter of 2023 has increased considerably owing to unfavourable developments in the gas market.

Economic output likely to stagnate in Q3, decline much more probable in Q4 2022 and Q1 2023

Government deficit down this year

Supportive fiscal policy will continue this year, but deficit likely to decline

Fiscal policy continues to stabilise macroeconomic developments, supporting households and enterprises with numerous measures this year as well. Nevertheless, the deficit is projected to be significantly lower than in 2021 (3.7% of GDP) as the fiscal burden caused by the coronavirus crisis eases. In the first half of the year, this was reflected in the sharp rise in tax revenue and the fall in pandemic expenditure. Accordingly, the budget outturns of central government, state governments and the Federal Employment Agency improved considerably in the financial statistics. As things currently stand, new burdens from the war in

Ukraine and measures to offset high prices will not outweigh this recovery.

Clear structural deficits expected in coming years

From 2023, significant structural debt likely for some years

At present, the deficit looks set to decline further in the coming years. However, a significant structural deficit is to be expected due to central government in particular. The Federal Government is planning to resume compliance with the standard limit under the debt brake from 2023, but this will be compounded by deficits generated by the use of existing reserves and in special funds. Altogether, this provides scope for structural central government deficits of just over 1½% of GDP on average between 2023 and 2026.

Uncertainty remains high

Nonetheless, the outlook for this year and the coming years is uncertain. The plans for the 2022 and 2023 Federal budgets still contain buffers, yet fiscal risks remain, especially as a result of the war in Ukraine and a potential energy shortage, and new fiscal measures are under discussion. Moreover, there is little transparency regarding how exactly the extensive leeway for deficits in the special funds is to be used.

Fiscal policy in a difficult macroeconomic environment

Government assistance to households and enterprises should not impede price signals

German public finances are still well positioned to stabilise the economy even in the event of less favourable developments. Should the economy weaken further, the government will first prop up income and demand automatically via the tax and social security systems. It is important that new supplementary support measures do not undermine price signals for supply and demand. High energy prices, for example, are a key incentive to reduce energy consumption. Ultimately, the government is only able to redistribute higher energy costs, which are reflected in rising prices – it is not able to provide enterprises and households with comprehensive relief, as the procurement of energy sources from abroad is now absorbing a larger share of economic output.

Broader deficit-financed fiscal stimulus is still not called for

From today's perspective, a broader deficit-financed fiscal stimulus is still not warranted. This is because price pressures are high, and supply-side disruptions persist. Additional government stimulus to demand is therefore likely to have relatively little impact in real terms and may threaten to amplify price pressures further. Any new measures deemed to be necessary would have to be counterfinanced elsewhere.

Return to regular fiscal rules next year remains advisable …

As things currently stand, a return to compliance with the standard limit under the debt brake next year remains advisable. Incidentally, this will not require slamming the brakes on fiscal policy, which would choke economic development. First, the deficit will shrink automatically, as it were, as coronavirus support measures that are no longer needed expire. Second, there is considerable scope for deficits beyond the debt brake's net credit limit from reserves and special funds.

… in order to strengthen confidence in reliable public finances as well

Trust in sound public finances is important to ensure that, amongst other things, the government can provide stability in crisis situations. Fiscal rules can safeguard sound public finances and thus establish confidence, which, in turn, also helps to ensure a stability-oriented monetary policy. To achieve this, however, the regular limits of the rules must be binding and must not be undermined. This applies to the German debt brake, but also to the European rules in particular. Emergency clauses have their place in crisis situations, but their use should remain an exception and plausible explanations should be given for their use. Measures financed by contingency borrowing should also be suited to counteracting the specific emergency situation.