The current economic situation in Germany

Overview

Inflationary pressures unabated despite economic weak spell

Global activity continues to deteriorate

Further slowdown in global economy

Global economic activity continued to deteriorate in the third quarter of 2022. Sustained, strong price pressures weighed on private consumption in particular. The tightening of monetary policy being pursued in many places also left its first marks. In Europe, exceptionally high energy prices and uncertainty about the future supply of energy were additional drags on economic activity. Growth in gross domestic product (GDP) therefore weakened markedly in the euro area. In Japan and the United Kingdom, economic output even declined somewhat. The steep growth in China was primarily due to the easing of pandemic-related restrictions. Gross domestic product in the United States also increased significantly, following a decline in the first half of the year. In both economies, though, the underlying cyclical trend remained subdued.

Commodity prices falling

Drop in industrial commodity prices and European gas prices

Given the global economic slowdown, the prices of many industrial commodities continued to fall over the past few months. European gas and electricity prices even dropped fairly significantly since the end of August, from their record levels. Key factors behind this were reduced consumption (partly on account of the weather), persistently high imports of liquefied gas and almost completely full gas storage facilities. Oil prices, by contrast, did not fall any further, but picked up again somewhat at the beginning of the fourth quarter. One reason for this was the decision made by OPEC and its partners to substantially reduce crude oil production from November onwards. Prices for some refined petroleum products, such as diesel and heating oil, even rose distinctly, mainly as a result of declining imports from Russia and low inventories. It was only recently that they came down again.

Consumer prices and wages seeing stronger growth

Increased broad-based consumer price inflation

The dwindling commodity prices did not lead to lower consumer inflation rates, however. On the contrary, consumer price inflation became even more broad-based globally owing to the protracted high level of cost pressure. In the euro area, annual inflation as measured by the Harmonised Index of Consumer Prices (HICP) rose to 10.6% by October, and the rate excluding energy and food climbed to 5.0%. Looking ahead, the declining commodity prices should dampen consumer price inflation. However, wage growth continued to increase in a number of advanced economies, which could prolong the inflation process.

Financial markets shaped by monetary policy normalisation

Financial markets centring on high inflation rates and expected tightening of monetary policy

The international financial markets were marked by the record inflation rates together with the continued tightening of monetary policy on both sides of the Atlantic. Yields in sovereign bond markets rose significantly, especially as key central banks signalled their willingness to raise interest rates again. In July, September and November, the Federal Reserve raised the policy rate by 75 basis points in each case to a target range of between 3.75% and 4%; the Eurosystem has increased key interest rates in multiple increments by a total of 200 basis points since July. Both central banks also envisaged further interest rate steps. Moreover, market participants are expecting the Eurosystem to soon end the reinvestment of maturing

bonds. At the same time, the risks of expansionary fiscal policy in times of a necessary tightening of monetary policy became more of a focus in the financial markets. In the United Kingdom, the announcement of non-funded tax cuts (which were later withdrawn) led to an abrupt increase in government bond yields. The Bank of England perceived this as a threat to financial stability and had to deviate from its course of monetary policy tightening to initiate temporary purchases of domestic government bonds and further support measures. This episode illustrates the tensions that interest rate policy normalisation can create in the financial markets if it is not flanked by appropriate fiscal policy.

The stock markets rebounded following the steep price losses in the previous quarters. Although the rise in interest rates and entrenched doubts about the economy continued to dampen prices, as of the fourth quarter reports of sizeable liquefied gas deliveries and high gas storage levels have revived investors' risk appetite and optimism, especially in Europe. Largely driven by the monetary policy tightening impulses of the Eurosystem and the Federal Reserve, the euro distinctly lost value against the US dollar initially, but subsequently largely made up the losses. In effective terms, by contrast, the euro gained value.

Further steep interest rate rises by Eurosystem

Monetary policy: ECB Governing Council significantly raises key interest rates twice in reporting quarter and …

The ECB Governing Council raised the three key ECB interest rates by 75 basis points twice, at its September meeting and its October meeting. The continued tightening of the monetary policy stance occurred because inflation remains high and is gauged to stay above the 2% medium-term target for an extended period. The risks to the inflation outlook are also still primarily tilted to the upside. The withdrawal of monetary policy accommodation is aimed at reducing support for demand and guarding against the risk of a persistent upward shift in inflation expectations.

… adjusts terms of TLTRO-III and remuneration on minimum reserves

In view of the unexpected and extraordinary rise in inflation, the Governing Council decided furthermore in October to change the terms and conditions of the third series of targeted longer-term refinancing operations (TLTRO-III). The recalibration was made to ensure consistency with the broader monetary policy normalisation process and to reinforce the transmission of policy rates to bank lending conditions. In addition, the ECB Governing Council adjusted the remuneration of minimum reserves held by credit institutions with the Eurosystem in order to align them more closely with money market conditions.

Credit growth defies tightening of financing conditions

Robust lending supports monetary growth

Influenced by the energy crisis and the uncertain economic outlook, the euro area's broad monetary aggregate M3 expanded more strongly again in the third quarter than it had done in the two weaker preceding quarters. One striking development on the components side was the strong growth in short-term time deposits, whose increased remuneration appears to have made this form of investment significantly more attractive. On the counterparts side, robust bank lending to non-financial corporations was a major contributor to monetary growth. The banks surveyed in the Bank Lending Survey (BLS) reported that they had tightened credit standards across all loan categories – significantly so, in some cases. However, unlike in the case of loans for house purchase, the tighter financing conditions were not yet significantly dampening growth in loans to enterprises in the reporting quarter. This is because firms' financing needs remained high, especially for working capital and inventories.

Strong demand for loans to enterprises in Germany, too

Robust uptick again in German banks' loans to domestic private sector

In the third quarter, banks in Germany, too, strongly expanded their lending to the domestic private sector once again, especially to non-financial corporations. The bulk of this was attributable to government assistance loans to energy companies, although other firms' demand for bank loans remained strong as well. This was due, inter alia, to the fact that bank loans continued to substitute for relatively expensive capital market financing. Marked inflows were likewise recorded in loans to households in the third quarter, although these were weaker than in the preceding quarters.

Q3 sees surprising growth in German economic output

Growth in German economic output in Q3 2022 contrary to expectations

Contrary to expectations, German economic activity expanded in the third quarter of 2022. Although high inflation and uncertainty about the future supply of energy weighed on the economy, real gross domestic product (GDP) grew by 0.3% on the quarter after seasonal adjustment according to the Federal Statistical Office's flash estimate. It thus exceeded its pre-pandemic level for the first time. The lifting of most of the coronavirus mitigation measures provided positive momentum in some services sectors. While households' reluctance to purchase owing to high inflation rates and uncertainty was felt in the retail sector, private consumption nonetheless rose markedly overall, thus proving more resilient than expected. Diminishing supply bottlenecks and a high order backlog boosted production in the manufacturing sector. Investment in machinery and equipment was also bolstered by the easing of pressure along supply chains. Construction activity weakened against the backdrop of high construction prices, reduced purchasing power and higher financing costs.

Labour market caught between labour shortages on the one hand and declining demand for labour on the other

In the third quarter, the labour market moved largely sideways in terms of both employment and unemployment. The previously very positive outlook deteriorated, however. At present, the labour market is caught between understaffing in many sectors, a high number of vacancies and long recruitment periods on the one hand, and declining demand for labour – especially in the areas hit especially hard by cost increases – on the other. This tight situation will therefore ease in the coming months, but the labour market is likely to remain broadly stable.

Elevated risk of second-round effects on inflation

Recent wage agreements set out larger wage increases and are specially structured

The third quarter of 2022 saw a continued moderate increase in negotiated pay rates. Nevertheless, a growing number of the most recent wage agreements have been strong. In particular, the annualised wage increases of 6% in the chemicals industry and of 5¼% in the metal-working and electrical engineering industries are much higher than usual for those sectors. The fact that these deals include payments that are tax-free and exempt from social security contributions make them more attractive to employees as it means that the wage increases are markedly higher in net percentage terms than in gross percentage terms. It is possible that enterprises, too, will find the combination of comparatively moderate permanent hikes and temporary "inflation compensation bonuses" to be more appealing than higher permanent wage increases.

Trade unions' wage demands exceptionally high

In view of high inflation, trade unions are calling for exceptionally large wage increases in the ongoing negotiations. For example, the trade union ver.di is demanding a 10.5% increase in wages for the public sector at the central and local government level for a period of 12 months. These demands are not expected to lead to actual wage settlements of the same magnitude. Although this does not suggest that wages are accelerating inflation, the risk of second-round effects has increased. These effects would increase the risk of the inflation

rate remaining well above the euro area's medium-term target of 2% for a longer period of time.

Double-digit inflation in Germany for the first time since the early 1950s

Despite relief measures, exceptionally dynamic rise in consumer prices continued into Q3

In seasonally adjusted terms, the exceptionally strong rise in consumer prices (HICP) continued into the third quarter. The already very high price increases for food in the previous quarters intensified once again. Consumer energy prices also continued their marked rise despite factors intended to bring relief. These include doing away with the renewable energy levy (EEG levy), falling crude oil prices and the fuel rebate, which was time-limited to the end of August. However, the alleviating effect of lower oil prices was curbed by the euro's continued depreciation. Other factors, such as higher transport costs for heating oil as a result of low water levels in Germany's inland waterways, also drove up prices. Lastly, consumer rates for gas were once again raised appreciably. In the case of non-energy industrial goods, consumer price inflation remained robust in line with price increases at the upstream stages. Prices for services rose just as sharply as in the second quarter, although the €9 ticket had a dampening effect until the end of August. In annual terms, the inflation rate as measured by the HICP was up by 9.4% in the third quarter, while the rate excluding energy and food hit 3.8%.

Inflation rate continued to rise in October and could remain in the double-digits in months ahead too

In October, prices again saw very sharp growth of 1.1% on the month in seasonally adjusted terms. Energy prices continued to rise markedly. Food and industrial goods prices excluding energy recorded a further strong increase. Annual headline inflation climbed to 11.6%, after reaching double-digit levels in September for the first time since the early 1950s. These double-digit inflation figures may even last into the new year. The government footing gas bills in December, which represents the first stage of the gas price brake, will relieve consumers. However, it is still unclear to what extent this will be reflected in the official price measurement and thus in the inflation rate. The second stage of the gas price brake, under which households would see a basic quota of 80% of their previous year's gas consumption estimated at a guaranteed price of 12 cents per kWh, could potentially dampen the inflation rate by almost one percentage point. Here, too, however, uncertainty regarding how this will be reflected in the official price measurement and the development of gas prices without a gas price brake is very high. This applies in equal measure to the electricity price brake envisaged for the beginning of 2023, which could temporarily further dampen the reported inflation rate. As soon as the gas and electricity price breaks expire, their impact on the inflation rate will be reversed.

Decline in GDP expected in Q4 2022 and Q1 2023

German economic output likely to decline significantly in Q4 2022 and Q1 2023

Economic output is set to contract in the final quarter of 2022 and first quarter of 2023. Uncertainty about the energy supply and the associated costs are weighing heavily on enterprises. According to ifo surveys, all sectors reported that the business situation and business expectations were worse in October than in the third quarter. Short-term production plans and export expectations in the manufacturing sector were predominantly pessimistic. The slowdown in global economic activity is likely to have an impact on exports, even though the extensive backlog of orders and receding supply bottlenecks in industry are somewhat mitigating the subdued demand. High inflation is also dampening private consumption and thus activity in the consumer-related services sectors. At the same time, the positive stimuli from the lifting of coronavirus protective measures are likely to diminish markedly. Furthermore, the government's pandemic-related consumption spending is likely to taper off. Hence, government consumption is coming down from its previously elevated level. Finally, construction

activity is likely to continue to cool down. Overall, this means that although economic activity was higher than anticipated in the third quarter, a recession is still to be expected in the final quarter of 2022 and the first quarter of 2023. However, the extent of the recession is extremely uncertain. At present, a gas shortage can probably be avoided.

Government deficits remain high

Government finances shaped less by coronavirus crisis but more by energy crisis and high inflation

Public finances continue to be shaped by crises. Although existing coronavirus measures are elapsing, the government is providing new financial assistance in response to inflation and the energy crisis. Macroeconomic developments and high inflation will initially have a positive impact on public finances: taxes and social contributions are generally tied to nominal variables (such as nominal private consumption and wages) which are seeing strong growth, whereas government expenditure will only reflect higher prices and interest rates to a fairly moderate extent at first. Over time, however, government spending will also rise more sharply as prices and interest rates increase.

Deficit expected to decline in 2022, but rise again in 2023

Overall, the deficit ratio is likely to fall markedly this year due to the prevalence of relieving factors: amongst other things, expenditure on coronavirus-related transfers to enterprises is falling and revenue is rising dynamically. The government deficit is likely to rise again in 2023, however. Transfers relating to energy price brakes, in particular, are likely to lead to considerable additional expenditure. How steeply the deficit climbs will depend to a large extent on the decisions taken in this arena – for example, when determining the level of counterfinancing for the electricity price brake. Looking ahead, new measures may also result in additional deficits.

Central government continues to shoulder most of the crisis burden …

Central government, in particular, is recording large deficits. It had already financed support measures via emergency loans during the coronavirus crisis and intends to do so during the energy crisis, too. While central government plans to once more comply with the standard limit under the debt brake in the core budget next year, it is mainly financing crisis assistance using the Economic Stabilisation Fund (ESF). To this end, it topped up this special fund by €200 billion this year via emergency loans. These are now expected to fund measures to address the energy crisis by mid-2024.

… and is further increasing its use of ancillary budgets

Separately, the Federal Government also transferred sizeable amounts of expenditure and borrowing to off-budget entities. For example, the Armed Forces Special Fund, Energy and Climate Fund and Flood Relief Fund have a combined additional deficit margin of around €200 billion, of which around half consists of coronavirus emergency loans. The deficit margins of the aforementioned funds for the coming years therefore amount to a total of around €400 billion, or roughly 10% of GDP. This corresponds to just over four-fifths of total expenditure in the Federal budget in the coming year. On balance, central government finances are becoming increasingly opaque, and the Federal budget only maps to central government activities to a limited extent.

Government put to test in energy crisis; energy saving incentives probably largely preserved

In view of the current crisis, use of the escape clause is understandable. The measures are also linked to the crisis, not least because they support households in need and hard-hit enterprises. The measures reduce uncertainty for households and enterprises by shifting energy cost risks to the government. It is vital that the electricity and gas price brake, as a core element of crisis assistance, preserves price incentives to save energy. This would be the case if the proposals of the gas price commission, which were adopted by a majority, were to be implemented. The government is compensating for large losses at gas trading companies (especially Uniper), electing not to take advantage of the potential for price adjustments in the contracts.

However, concrete action is heavily straining fiscal rules

The fundamental aim of the debt brake is to set a narrow framework for net borrowing. This year, the ESF will receive a very high borrowing authorisation under the escape clause. The gas price brake is broadly based. This also seems to apply to the electricity price brake, although the design of these transfers is not yet final. The funds required can be reduced by limiting transfers to individuals and enterprises that would face excessive burdens without assistance. If policymakers opt for a broader approach, stronger counterfinancing would make sense.

Do not hamper monetary policy through sharply rising deficits

Supply bottlenecks are currently in place and inflation is high. Monetary policymakers must respond appropriately to high inflation rates, with raising policy rates in particular being one way of fulfilling their tasks. In the current situation, public finances should not increase price pressures. Given the above, there is an argument to be made for restricting government credit financing fairly tightly and at least avoiding a larger increase in the deficit next year. It should be borne in mind that the government can only spread higher energy costs out over a longer period, or redistribute financing costs. Sooner or later, it will be forced to finance the measures by increasing revenue or reducing expenditure elsewhere.

Improve EU fiscal rules

The European Commission's proposal for the reform of fiscal rules is not convincing

Improving EU fiscal rules would be vital to ensure the resilience of government finances in the euro area. The European Commission's current reform proposal is not convincing. It proposes that it negotiate country-specific fiscal targets for the coming years with each individual Member State, taking many aspects into account, using assumption-driven long-term calculations and giving the Commission considerable discretion. There is a danger that fiscal limits will be softened, and that the process of determining them will become nearly entirely opaque. The reduction of high debt ratios could thus be considerably delayed in line with the rules. Nevertheless, sound public finances remain the cornerstone of a stability-oriented monetary union. It is ultimately vital for countries to agree on binding and sufficiently ambitious fiscal rules.