The current economic situation in Germany

Overview

Economic outlook somewhat brighter, high inflationary pressures persist

Global economy growing moderately amidst improving sentiment

Subdued global economic activity, but sentiment brightened at turn of the year

The global economy continued to see only moderate growth in the final quarter of 2022 owing to various headwinds. The main factors behind this slowdown were high inflation rates, the continued tightening of monetary policy in many industrial countries and the European energy crisis due to Russia's war on Ukraine. Accordingly, there was weak economic momentum in the euro area, although it was somewhat stronger than had been expected just a few weeks ago. In the United States, gross domestic product (GDP) rose markedly in the fourth quarter, but the underlying cyclical trend also remained subdued. In China, economic growth was initially halted by fresh lockdowns and then by a massive wave of infections after all of the containment measures were suddenly lifted. At the turn of the year, sentiment amongst entrepreneurs and consumers worldwide brightened slightly, with recessionary fears receding somewhat. This is likely to have been helped by the distinct easing of the European energy crisis. Inflationary pressures also slackened somewhat. Ultimately, the end of the zero-COVID policy in China is likely to pave the way for economic recovery.

Further fall in prices for energy commodities

Prices of energy commodities fell significantly in some cases

European gas and electricity prices fell significantly in the reporting period. This was partly due to the fact that the gas storage facilities remain well filled owing to mild winter temperatures, high imports of liquefied natural gas and the efforts of enterprises and consumers to curb usage. International crude oil prices also declined somewhat thanks to the abundant supply on the world market. Russia is evidently still managing to redirect its oil exports away from sanctioning countries and towards China and India.

Strong consumer price inflation eases somewhat

Decline in inflation rates, underlying inflation persistently high

As energy commodity prices abated, consumer price inflation in industrial countries also weakened slightly. Headline inflation in this group of countries fell to 7.6% in December 2022; it had been almost 1 percentage point higher three months earlier. Looking ahead, lower energy prices are likely to dampen inflation further. Producer prices for intermediate goods in the manufacturing sector have fallen recently in most industrial countries. This is likely to curb price inflation for goods in particular. However, the underlying inflationary pressures may prove to be more persistent given the robust labour market situation and high wage growth. Inflation excluding energy and food has so far retreated only tentatively to 5.4%.

Financial markets shaped by very high inflation

Financial markets focusing on high inflation rates and differing economic outlooks

Persistently high inflation rates also shaped developments in the international financial markets. Central banks continued to tighten globally, although they have now been taking smaller interest rate steps to raise policy rates in the context of more restrictive monetary policy stances. The Federal Reserve, for example, has adjusted the key interest rate upwards in three additional steps since the end of September, but most recently by only 25 basis points in February. The Eurosystem, too, reduced the size of its increments from the previous level of 75 basis points; the steps in December and

most recently in February 2023 were each increases of 50 basis points. Since the beginning of the year, market participants have increasingly had the impression that inflation could fall faster throughout the year than initially assumed. This impression was aided by the publication of inflation figures that were lower than in previous months and, in some cases, lower than expected. This was the main reason why long-term yields in the sovereign bond markets initially all but ceased their upward trajectory that they had begun at the start of 2021. As the economic outlook clouded over, they even declined in the United Kingdom compared with the end of September, whilst in the United States they remained virtually unchanged. By contrast, yields in the euro area were bolstered by energy markets stabilising, economic prospects improving throughout the single currency area and China moving away from its zero-COVID policy. Equity markets saw strong price gains, especially in the euro area. The brighter economic outlook and the market's assessment of declining upside risks to the inflation outlook increased risk appetite and investor optimism. The first quarter saw the euro appreciate in effective terms and against the US dollar, likewise benefiting from the marked improvement in the domestic economic outlook as viewed by the market.

Eurosystem continues course of significant and steady interest rate rises

Monetary policy: ECB Governing Council raises key interest rates again twice and …

The Governing Council of the ECB raised the three key ECB interest rates by 50 basis points at both its December 2022 meeting and its February 2023 meeting. It will stay the course in raising interest rates significantly at a steady pace, and keep them at levels that are sufficiently restrictive to ensure a timely return of inflation to the 2% medium-term target. In view of the underlying inflationary pressures, the Governing Council intends to raise interest rates by another 50 basis points at its monetary policy meeting in March and will then evaluate the subsequent path of its monetary policy. Its future policy rate decisions will continue to be data-dependent and follow a meeting-by-meeting approach.

… decides to scale back APP reinvestments

Furthermore, in December 2022 the Governing Council decided on the principles for normalising monetary policy securities holdings. From the beginning of March 2023 onwards, the asset purchase programme (APP) portfolio will be reduced by €15 billion per month on average until the end of the second quarter of 2023. The subsequent pace will be determined over time and regularly reassessed. The Governing Council supplemented this in February with a decision on the technical modalities.

Supply-side and demand-side factors weaken credit growth

Sharp decline in lending weakens monetary growth in the euro area

With monetary policy being tightened, growth in the broad monetary aggregate M3 diminished sharply in the fourth quarter of 2022. The rise in money and capital market yields increased the opportunity costs of holding money, prompting investors to make shifts in their portfolios, both out of the monetary aggregate M3 and within it. On the supply side, a sharp decline in loans to the non-financial private sector in the euro area dampened monetary growth. Demand for loans on the part of enterprises and households was weakened in particular by uncertainty surrounding the economic outlook and higher financing costs. In addition, credit growth is likely to have been subdued by the ongoing tightening of banks' lending policies, which according to the Bank Lending Survey (BLS) continued in the quarter under review. The banks surveyed by the BLS again mainly put this tightening down to what they viewed as an increase in credit risk.

German economic output down in Q4 2022

German economic output lower in Q4 2022 than in Q3

German economic output was lower in the fourth quarter of 2022 than in the previous quarter. According to the Federal Statistical Office's flash estimate, GDP decreased by 0.2% on the quarter after seasonal adjustment, which would mean the decline in economic output was milder than anticipated in the December projection. The situation in the energy markets eased markedly over the course of the quarter and prices for energy commodities moderated. Furthermore, output in the manufacturing sector remained more resilient than expected overall. This was partly due to supply bottlenecks easing further and the well-filled order books making up for the decline in new orders. The automotive industry, in particular, stepped up production markedly in the final quarter of 2022. This more or less offset the decline in output in energy-intensive sectors. Meanwhile, high inflation eroded consumer purchasing power and real sales in the retail sector dropped considerably. Private consumption is therefore likely to have contracted markedly. Construction activity also weakened further, mainly as a result of falling demand for construction services. Demand for these services is suffering due to the high construction prices, reduced household purchasing power and increased financing costs.

German banks' lending to domestic private sector significantly weaker

These factors contributed to a slowdown in lending to the domestic private sector and, above all, to non-financial corporations. Although part of this was swingback coming after the exceptionally strong growth in lending in the preceding quarters, the tighter financing conditions and the uncertain macroeconomic environment, which dampened enterprises' willingness to invest, also played a key role. Extensive return flows from government assistance loans to energy companies, mainly stemming from the restructuring of government support, were a further aspect. Lending to households also continued to lose momentum in the fourth quarter. Households' demand for housing loans, in particular, declined compared with the previous quarters.

Labour market developments more favourable than expected

The labour market improved again in the fourth quarter of 2022. Employment rose slightly in the fourth quarter, after recording next to no growth in the third quarter. Unemployment remained stable at a low level. This meant that the expectations expressed in the December projection were exceeded. Despite the recessionary outlook and sharp increase in the minimum wage, robust labour market developments were already anticipated. The short-term outlook is also more favourable at present than it was just a few months ago.

High wage increases agreed in recent wage agreements

Recent wage agreements again contain significantly larger wage increases than in previous years

Although the fourth quarter of 2022 saw a continued moderate increase in negotiated wages, the most recent wage agreements were once again significantly higher than in previous years. It is noteworthy that a growing number of (tax-free and social contribution-exempt) inflation compensation bonuses have been agreed in some sectors in addition to the increase in scheduled rates of pay. Unscheduled renegotiations of current wage agreements took place to this end in a handful of branches. At present, wage demands are also exceptionally high by historical standards. The old, moderate wage agreements from the period before inflation was high will expire this year. The significant wage increases set out in the new collective wage agreements will increasingly be reflected in higher growth in negotiated wages overall.

Second-round effects helping prolong the period of high inflation rates

This year's pay round will be shaped by high inflation and labour shortages on the one hand, and by the sluggish economic activity at present and uncertainties due to geopolitical risks, on the other. Furthermore, negotiations will be made more difficult by the restricted scope for wage distribution. This is because Germany is losing purchasing power and wealth due to the

country being a net importer of energy, which is now massively more expensive. The impact of high rates of inflation is already clearly discernible in the latest wage agreements. Marked second-round effects on prices are to be expected. They will help ensure that inflation remains well above the medium-term target of 2% for the euro area for an extended period of time.

Peak level of inflation exceeded in Q4

Strong price increases in Q4 2022, too

The sharp rise in consumer prices also continued in the fourth quarter of 2022. Between October and December, the Harmonised Index of Consumer Prices (HICP) increased by an average of 2.6% on the quarter in seasonally adjusted terms, thereby exceeding the growth of 2.1% recorded in the third quarter. The renewed increase in momentum was mainly driven by the additional surge in prices for services. First, the temporary introduction of the €9 travel ticket in the early summer no longer had a dampening effect. Second, the statutory minimum wage was raised substantially in October. By contrast, the energy component lost some momentum as a result of the government covering advance payments for gas in December (immediate assistance) and declining crude oil prices. Compared with the previous year, the HICP rate increased by 1.4 percentage points to 10.8% in the fourth quarter, while the rate excluding energy and food grew from 3.8% to 5.2%.

Inflation rate down slightly further in January and likely to fall further in the coming months

The HICP rate is estimated to have fallen from 9.6% in December 2022 to 9.2% in January 2023. Detailed information on the adjustment of the underlying basket of goods will only be known once the final figures have been published on 22 February 2023. The HICP weighting scheme may have changed markedly as the further decline in inflation came as a surprise. Based on the old weighting scheme, a significant increase would have been expected due to the absence of the dampening effect generated by December's immediate assistance scheme. The electricity and gas price brakes, which are already captured in the price statistics in January, will probably be of less significance. The inflation rate is likely to fall further in the coming months. For instance, the sharp rise in energy prices in the previous year will no longer impact the calculation of the rate in March. However, the underlying pressure on prices is likely to decline only tentatively from an exceptionally high level over the next few months.

Economic activity picking up slightly following a renewed decline in GDP in Q1

German economic output likely to be lower again in Q1 2023 than in Q4 2022

Economic output is likely to be lower again in the first quarter of 2023 than in the previous quarter. On the one hand, a gas shortage is no longer to be expected. In addition, the electricity and gas price brakes are mitigating the increase in energy costs for households and enterprises. Tensions in the energy markets and uncertainty have eased considerably. This is likely to benefit primarily business investment, but also industrial production. The latter should remain relatively robust in the first quarter amid supply bottlenecks continuing to ease and well-filled order books. On the other hand, industrial production started out from a depressed level in 2023 following the marked decline in December 2022. This also applies to exports, which are being dampened by declining foreign demand as well. Moreover, inflation remains high and continues to eat into households' purchasing power. Private consumption is therefore also likely to decline at the beginning of 2023. Lastly, construction activity will probably continue to slow down.

Slight pick-up over the remainder of the year, but no major improvement yet

Although there could be a gradual pick-up over the remainder of the year, no major improvement is yet in sight. All in all, from today's perspective, Germany's economic output is likely to decline slightly on average in 2023 but per-

form a little better than expected in the December projection.

Government deficit to rise again in 2023

Deficit ratio set to increase this year

The pandemic drawing to an end, new fiscal support measures and high inflation are all shaping government finances. Last year, relief outweighed burdens and the deficit ratio fell by 1 percentage point on the year to 2.6%. The current budget plans set the stage for a renewed rise in the deficit ratio this year. The volume of temporary support measures remains high, primarily as a result of the broadly based electricity and gas price brakes. Their cost hinges on prices for final energy consumption, which are more stable; there will probably be a lag before the unexpected fall in prices on the energy markets is reflected in prices for final consumption. Overall, expenditure is likely to rise much more sharply than revenue. This is due, amongst other things, to the fact that high inflation is further driving up the cost of government tangible goods purchases and investment. In addition, spending on defence and climate policy will probably rise significantly. By contrast, given the boom in profit-related taxes last year, government revenue now appears likely to grow at a much slower pace.

Falling deficit in 2024, off-budget entities also significant in the medium term

Deficits smaller but still marked in medium term: climate and defence expenditure, in particular, largely credit-financed

The temporary support measures will probably largely come to an end next year, leading to a significant decline in the deficit. However, it is unlikely to fall back down to the regular borrowing limits under the debt brake any time soon. Although central government's core budget will start to comply with the limit again in 2023, during the period covered by the medium-term financial plan there are still considerable deficits in its off-budget entities, especially the Climate Policy Fund and the Armed Forces Fund. Moreover, the state governments built up substantial buffers during the crisis years. Over the next few years, these will probably not be used solely for upcoming repayments but for other purposes, too. Deficits at the state government level therefore also appear to be on the cards.

Overview of budgetary planning made more difficult by off-budget entities with high scope for deficits

Off-budget entities with large reserves or credit authorisations make it more difficult to gain an overview of budgetary planning. For example, central government envisages that its core budget deficit will fall significantly to around €85 billion but, when combined with the off-budget entities, its deficit is set to rise sharply to €230 billion. The plans extending to 2026 issued in the summer of 2022 point to a stable overall central government deficit of around €70 billion over the medium term. The core budget then accounts for only one-fifth (€14 billion) of this figure. For 2023, the plans for central government's off-budget entities are still largely transparent. However, hardly any specific figures are budgeted for the following years.

Limit deficits, strengthen fiscal rules again

Support measures are relatively broadly based and largely financed with new debt

Last year, there was a swift fiscal policy response to the fallout of the war in Ukraine and the high inflation rates. The support measures were broadly based and largely financed with new debt. This is part of the reason why the deficit is set to rise in the highly inflationary environment. A growing deficit, in and of itself, makes it more difficult for monetary policy to lower inflation. In principle, this would suggest that it would be appropriate to confine assistance payments, as far as possible, to those in need, and ensure timely counterfinancing. Positive fiscal surprises should not be interpreted as additional fiscal scope. Instead, they should result in lower deficits.

Apply fiscal rules effectively again: in Germany and …

It is important to apply the fiscal rules effectively again in the future. If they continue to be stretched, they will forfeit their binding effect and credibility and will no longer act as a safeguard for sound public finances. If the debt brake is seen as requiring amendment, it should be reformed transparently and, if necessary, the changes written into Germany's Basic Law. The Bundesbank has made reform proposals to this effect.

… in the EU

The EU fiscal rules are designed to ensure sound public finances in the individual Member States. They are thus essential for a stability-oriented monetary union. The European Commission's reform proposal of November 2022 is unconvincing in this respect: in place of shared standard limits, it envisages rules that can be adapted individually for each country. This would pose a substantial threat to the objective of the fiscal framework. This could be avoided if the reform debate were instead focused on adjusting the existing rules in a manner conducive to maintaining stability. In its latest Annual Economic Report, the Federal Government outlined its ideas for a reform of the framework, arguing in favour of considerably stricter fiscal rules than the European Commission's proposals envisage.