The current economic situation in Germany

Overview

Activity stagnating and inflation still too high in Germany

Global economy makes solid start to 2023, outlook rather subdued

Solid start to year for global economy

The global economy got off to a solid start in 2023. Stimuli for growth came primarily from China, where real gross domestic product (GDP) rose significantly after the end of the country's zero-COVID policy. At the same time, economic activity in the euro area picked up again, partly thanks to a distinct easing of the situation in energy markets. Fears of a recession have so far proven unfounded in the United States, too, with moderate economic growth continuing, driven by consumers' readiness to spend.

Global economic activity remains subdued, with increased downside risks

Despite the solid start to the year, the global economic environment is likely to remain challenging. While the upturn in China is set to continue at a moderate pace, stubbornly high inflation and tighter monetary policy are putting the brakes on activity in almost all advanced economies. Added to this are risks stemming from the recent turmoil in the banking system, especially in the United States.

Global inflationary pressures easing only slightly

Inflation rates coming down, but underlying price pressures still high

Falling energy prices and base effects led to a decline in consumer inflation rates around the world. Annual inflation in the group of advanced economies dropped to 6.0% by April. However, underlying price pressures have barely subsided thus far. In April, the annual rate of change in consumer prices excluding energy and food stood at 5.5%. Price growth remained high in the services sector, in particular, where costs are strongly influenced by wage developments. It also remains to be seen whether further energy price relief can be expected in the near future. In the wake of the decision by OPEC and its partners to significantly cut crude oil production from May onwards, there is a risk that the oil market will be undersupplied in the second half of 2023.

Financial markets coping well with US bank turmoil

Persistently high inflation rates and bouts of distinct tension in US regional banking system are focus of financial markets

Since the beginning of the year, international financial markets have been contending with persistently high inflation rates and bouts of distinct tension as a result of the bank turmoil in the United States. Major central banks tightened their monetary policy stance further at the start of the first quarter in view of the inflation outlook. They also signalled that further interest rate rises would be necessary in order to ensure a timely decrease in inflation. The collapse of several US regional banks led to concerns about the stability of the financial system from mid-March onwards. Market uncertainty soared amid fears of contagion effects, triggering a flight to safe assets which significantly reduced yields on safe securities. At the same time, market participants revised their expectations about the paths of policy rates downwards – especially for the United States. Markets assumed that the US regional banking crisis could lead to deteriorated financing conditions there over a longer period. By contrast, the collapse of Switzerland's Credit Suisse was only a temporary strain on the international financial system.

As the reporting period progressed, the spillover effects on international financial markets emanating from the United States receded again. In combination with favourable economic releases, especially for the euro area, a growing appetite for risk and further policy rate hikes, this stabilised bond yields on both sides of the Atlantic. In equity markets, as well, the

bank turmoil had only a temporary and comparatively moderate impact; overall, both the broad Euro Stoxx index and European bank equity prices recorded marked gains. The euro has also been trading more strongly on balance in the year to date, including against the US dollar and the Japanese yen. It thus continued its effective appreciation from the final quarter of 2022.

Eurosystem continues raising key interest rates and …

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

At its monetary policy meeting in March 2023, the Governing Council of the ECB raised the three key ECB interest rates by another 50 basis points each. In May, it decided to raise interest rates again, but reduced the pace to 25 basis points. The Governing Council stated that its future decisions will ensure that the policy rates will be raised to levels sufficiently restrictive to achieve a timely return of inflation to the 2% medium-term target and will be kept at those levels for as long as necessary. The Governing Council will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction. Further policy rate decisions will be based on the assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation and the strength of monetary policy transmission.

… decides to discontinue reinvestments under the APP

… decides to discontinue APP reinvestments

The Governing Council of the ECB also decided in May that it will keep reducing the Eurosystem's asset purchase programme (APP) portfolio at a measured and predictable pace. In line with these principles, the Governing Council expects to discontinue the reinvestments under the APP as of July 2023.

Rising interest rates lead to portfolio rebalancing and dampens loan demand

Tightening of lending policies continues as planned, no noticeable impact from bank turmoil

As the monetary policy stance tightened, growth in the broad monetary aggregate M3 continued to weaken substantially in the first quarter of 2023. The increase in money and capital market yields led to large-scale portfolio shifts by the money-holding sectors away from highly liquid, low-interest deposits into higher-yielding forms of investment, including longer-term bank debt securities. On the supply side, the reduction in bond holdings and weak bank lending to the private sector slowed monetary growth. First, the subdued economic outlook and the increased financing costs had a dampening effect on loan demand from enterprises and households. Second, banks' tighter lending policies braked loan growth. According to the Bank Lending Survey (BLS), the surveyed banks continued to tighten their credit standards in the first quarter as planned at the beginning of the year, pointing to the rise in credit risk as the main justification. By contrast, the turmoil in the US and Swiss banking sectors in March had no discernible impact on the lending policies of banks in the euro area.

German economy stagnated in Q1

German economy flatlined in Q1 2023

The German economy moved sideways in the first quarter of 2023, having shrunk in the previous quarter. According to the Federal Statistical Office's flash estimate, real GDP remained unchanged on the quarter after seasonal adjustment. High inflation weighed on private consumption expenditure and consumption-related service providers. Government consumption declined as well, with the phasing out of pandemic-related expenditure likely to have played a key role. By contrast, the easing in energy markets, high order backlog and diminishing supply bottlenecks gave a boost to industry. Exports of goods picked up again, too. Construction activity benefited from the

relatively mild weather conditions at the beginning of the year, while high construction prices and increased financing costs weighed on demand for construction work. Economic output in the first quarter was somewhat weaker overall than recently expected. This is notably because, after making a buoyant start to the year, industrial activity suffered a setback in March that noticeably curbed output growth in the first quarter. New orders, which had picked up previously, also fell back significantly in March, with intermittent signs that demand for industrial products might bounce back failing to materialise.

Labour market very robust

In the labour market, the marked increase in employment seen in the autumn continued into the first quarter of 2023. Unemployment also came in somewhat higher in recent months, however, and there was a further slow decline in the number of vacancies. Leading indicators point to only fairly minor improvements in what otherwise remains a robust labour market in the coming months.

Lending weakens further

German banks' lending to domestic private sector tails off further

Against this backdrop, lending to the domestic private sector tailed off further in Germany, too. Loans to non-financial corporations remained weak. Two factors were at play here. First, firms once again redeemed a fairly substantial portion of the short-term loans they had taken out in the previous year to counter the supply bottlenecks and high energy prices. Second, the subdued economic outlook and tighter financing conditions put a damper on demand for longer-term loans. Lending to households likewise continued to lose momentum in the first quarter. In view of the elevated construction prices, the continued rise in financing costs and the loss of purchasing power brought about by the high inflation, demand fell for loans for house purchase in particular.

Significantly stronger rise in wages

Recent wage agreements higher than in previous year

Negotiated wages rose considerably more strongly in the first quarter than they did in the autumn. The most recent wage agreements, for example those in central and local government and at Deutsche Post, also came in at above average levels and exceeded the wage increases agreed last year. These agreements have made greater use of inflation compensation bonuses in combination with a rise in scheduled rates of pay.

Second-round effects on prices to be expected

Inflation, which is now broad-based and rather persistent, is increasingly leaving its mark on wage rises. Employers in areas not bound by collective labour contracts are also making greater use of the possibility of paying inflation compensation bonuses. With regard to the current wage rounds, the expected improvement in economic activity and reduced uncertainty surrounding the energy supply are providing tailwinds for efforts to do more than hitherto to offset past real wage losses. There is much to suggest that firms will pass on part of the increased wage costs through their prices as the year progresses.

Underlying price pressures remain very high

High inflation eased somewhat in first quarter on back of lower energy prices

Consumer prices (HICP) rose less sharply at the beginning of the year than in the preceding quarters. On average for the months of January to March 2023, they increased by a seasonally adjusted 0.9%, compared with 2.6% in the final quarter of 2022. Looking at the year-on-year figures, the inflation rate declined from 10.8% to 8.8% in the first quarter of 2023. Inflation mainly receded because energy prices dropped again during the quarter for the first time in two years. The price dynamics of the non-energy components of inflation remained very high, however. Excluding volatile components such as energy, food, travel services and clothing, the inflation rate rose significantly in

the second quarter, climbing from 5.0% to 5.8%.

Inflation rate still high in April and falling only gradually

In April, inflation barely came down from its very high level and thus remained higher than expected, with consumer prices rising by 7.6% on the year, after 7.8% in March.[1] The core rate excluding energy and food fell only slightly, dropping from 5.9% in March to 5.6%, which left it well above expectations. In the coming months, the inflation rate is expected to continue to decline, albeit only very gradually, in line with flattening price developments at upstream stages of the economy. The still exceptionally high price increases for non-energy components, the continued perceptible price pressures along supply chains, and the robust wage growth are counteracting the dampening impact of falling energy prices.

Slight increase in GDP expected in the second quarter

Economic output expected to rise again slightly in second quarter of 2023

Economic output is expected to rise again slightly in the second quarter of 2023. Diminishing supply bottlenecks, large order backlogs and lower energy prices are all supporting the continued recovery in industry. This is also likely to bolster exports, especially as global activity has regained some momentum. Despite continued high inflation, robust wage increases should at least mean households' real net income does not fall any further. Private consumption is therefore likely to stagnate, more or less. Construction, on the other hand, looks set to see output decline. The sharply lower demand is likely to take its toll and the tailwinds once provided by the mild weather conditions will fade.

Public finances in 2023 far brighter than planned

Public finances in 2023 proving to be far brighter than planned

Germany has so far weathered the energy crisis better than the adverse scenarios were predicting. Public finances are faring better as well. In particular, the lower energy prices are reducing the cost to government of the energy price brakes and the assistance provided for gas trading companies. As things stand today, the deficit ratio is likely to remain broadly unchanged at around 2½% this year. By contrast, last autumn's plans foresaw a significant increase to over 4%.

Deficits still financed via emergency loans in the medium term, too

Deficit to decline in 2024 before moving broadly sideways, but new budgetary burdens discussed

As things stand today, the deficit ratio will fall to somewhere between 1% and 1½% next year, mainly because the temporary support measures created in the wake of the energy crisis will for the most part expire. In the medium term, the deficit ratio could move sideways. However, central government is discussing new budgetary burdens, such as higher defence spending and subsidies for cheaper industrial electricity. It has not yet agreed on a new financial framework from 2024 onwards.

Debt brake escape clauses to take effect in medium term

While it is true that central government and most federal states are no longer making formal use of the debt brake escape clause, central and state governments have created scope – by means of the Armed Forces Fund and unallocated emergency loans – to run up substantial deficits in the medium term that far exceed the standard limits of the debt brake. A Federal Constitutional Court ruling on coronavirus emergency loans in the Climate Fund is pending. This ruling could also provide general indications as to the extent to which it is permissible to fund future deficits upfront using emergency loans.

1 The CPI figure was 7.2%, after 7.4%.

Transparency of central government's finances diminished

Federal budget now only partially reflects central government finances

It is becoming increasingly difficult to keep track of central government finances and their interaction with the debt brake. Transparency has deteriorated. Central government is patting itself on the back for complying with the debt brake again in the current year, but at the same time, it is budgeting for a very high deficit of €231 billion, of which €146 billion is in its off-budget entities. Some of the borrowing authorisations, justified using the coronavirus crisis or the energy crisis, were formally exhausted in 2021 and 2022; the bulk of the funds, however, were parked initially. The deficits of the Armed Forces Fund, for which parliaments have enshrined dedicated borrowing authorisations in the Basic Law, do not count towards the debt brake. Furthermore, central government does not report what obligations will be added this year under new EU borrowing for Next Generation EU (NGEU). Only NGEU revenue has been included.

Do not rebudget savings from crisis measures

Low energy prices automatically reduce deficit

The budgetary burdens arising from energy price brakes and payments to gas trading companies are likely to be significantly lower than planned. This is because lower energy prices ease the burden on the private sector; the fiscal measures that follow on from this are correspondingly cheaper. Much like automatic stabilisers, the costs to government respond automatically to economic developments, so if deficits are lower as a result, this is not an expression of a more restrictive fiscal policy.

To avoid making monetary policy more difficult, do not rebudget resources left over from crisis assistance

It would not be appropriate for the economy as a whole for the new borrowing originally budgeted for energy price assistance – but which is no longer needed – to now be used elsewhere. This would increase the degree of fiscal expansion, which is likely to in turn increase inflationary pressures. In the current environment, the fiscal policy stance should not make the task of monetary policy more difficult. This is another reason why Germany and the other euro area Member States should limit deficits. Broad-based crisis assistance should be phased out in a timely manner.

Reinforce the binding effect of fiscal rules

Reliably safeguard government's ability to act

There is no doubt that climate change, the energy transition and the geopolitical situation will put policymakers to a stiff test for quite some time. Debt-limiting fiscal rules do not prevent government from taking action. They do, however, force it to set priorities. This means scaling back less important expenditure or generating additional revenue. Sound public finances are not at odds with forward-looking government activity – far from it. Rather, they are its basis, ensuring that government is able to act even in crises.

Debt brake needs to be more binding once again, possibly with a somewhat broader regular borrowing framework

The debt brake makes for a comparatively restrictive borrowing framework, so there does appear to be scope for a stability-oriented reform; one which leaves somewhat greater room for manoeuvre as long as the debt ratio is relatively low. At the same time, however, such a reform should strengthen the binding effect of the rules again, which has diminished over the past few years. Only when fiscal rules are as binding as they are intended to be will they prevent fiscal policymakers from repeatedly passing on the costs of their decisions to future generations and putting monetary policy under pressure.

EU fiscal rules at risk of being weakened

The European fiscal rules are designed to safeguard sound public finances in EU Member States. This is important for stability-oriented monetary policy in particular. At the end of April, the European Commission presented draft regulations for a reform of the fiscal rules. On the whole, these proposals threaten to weaken the rules considerably. This increases

the risk that Member States will be slow to reduce high debt ratios. The proposed reform envisages less uniform fiscal rules and more bilateral scope for negotiation. It would see the European Commission working with individual countries to stake out multi-year adjustment plans, with reform and investment projects allowing deadlines to be extended. Macroeconomic and fiscal surveillance procedures would become interconnected, giving the European Commission an even more central role to play in fiscal surveillance and granting it a higher degree of discretion. However, the European Commission has a broad remit and pursues more than just the objective of fiscal soundness. This will inevitably lead to conflicts of interest. The new country-specific targets are mainly the result of complex and highly assumption-driven sustainability calculations. This will not make the new rules any easier to comprehend. Public perception could sour as a result, thus eliminating a key oversight pillar. Member States' negotiations on the European Commission's legislative proposals are ongoing and they are still able to amend them.