Overview

German economy still lacklustre amid persistently high inflation

Global activity subdued

Global economy still negatively impacted by fallout from strong inflation

Global activity remained subdued in the second quarter. Private consumption in particular was slow to gain traction because although inflation eased, it was still strong in many places. At the same time, the tighter monetary policy stance in many regions is likely to have been an increasing drag on the global economy. In the euro area, this backdrop meant that it was only thanks to irregular effects that the economy was able to register perceptible growth. Economic activity in the United States, by contrast, remained in comparatively good shape. In China, meanwhile, the recovery set in motion by the end of the zero-COVID policy quickly lost momentum.

Global industrial activity weak in particular

Around the world, industry in particular was impacted by the frail economy. Industrial production worldwide and global trade have been lacklustre for more than a year now. Surveys of manufacturing firms are showing no signs of a turnaround. Quite the opposite: purchasing managers' indices indicate that output and new orders were down again in July. This malaise now appears to have spilled over into the services sector, where growth had previously been fairly brisk. By contrast, consumer confidence in a number of large advanced economies increased markedly, probably on the back of the continued robust labour markets and the prospect of a renewed upturn in real incomes.

Price pressures easing worldwide, but inflation rates still high

Inflation rates on the decline worldwide

The past few months have seen consumer price inflation rates decline significantly around the world, even if they were still high in many places. By July, annual inflation in the group of advanced economies had dropped to 4.3%, largely on account of the significantly lower energy prices. It would also appear that underlying inflation has now passed its peak, with the core rate declining to 5.0% as this report went to press. At the same time, however, the impression took hold that inflation rates will nonetheless persist for longer above the rates targeted by central banks. In particular, the ongoing high wage pressures could make it harder to press ahead with curbing inflation. It also appeared that no further relief was forthcoming from commodity markets as this report went to press. In fact, crude oil prices have even picked up again noticeably since the end of June.

Global financial markets: all eyes on inflation outlook

Yields up amid persistent core inflation and monetary policy tightening

The inflation outlook shaped events in financial markets. Price pressures turned out to be unexpectedly persistent, mainly for the less volatile core components of consumer prices. Labour markets, which are crucial for the pace at which inflation declines, proved to be robust as well. This is the background against which central banks in most major currency areas decided on further policy rate increases and made it clear that the degree of monetary policy restriction would continue to increase. Only towards the end of the period under review did expectations emerge – especially for the United States – that the end of the rate hike cycle might be reached in the near future. Risk-free

yields in bond markets rose on balance over the reporting period.

Sentiment in the markets for risky asset classes was upbeat overall, as reflected in a robust appetite for risk which was also buoyed by the continued decline in uncertainty surrounding the US regional banking sector. This led to a drop in the yield spreads on less liquid bonds, corporate bonds and some other government bonds, including in the euro area. The ECB Governing Council's decision not to reinvest the principal payments from maturing securities under the asset purchase programme (APP) as of July 2023 also did not prompt any reassessment of the differences in credit quality across European government bonds.

Diverging economic outlook leads to mixed developments in global equity markets

In equity markets, investors' persistently strong appetite for risk combined with a more robust US economy provided a significant boost for the US S&P 500 index; in Europe, by contrast, the gloomy economic outlook for the euro area meant that the EURO STOXX index posted minor losses. Overall, the monetary policy measures taken are passing through to financing conditions in the euro area capital market roughly as strongly as past experience would suggest. Market participants' assessments of underlying price pressures in the different currency areas, and thus their view of future central bank policy, provided key impetus for foreign exchange markets as well. In this context, the euro appreciated for a time against the US dollar, but was unable to hold onto its gains, with the result that the exchange rate remained almost unchanged on balance.

ECB Governing Council raises key interest rates further

Monetary policy: ECB Governing Council raises key interest rates twice by 25 basis points and …

The ECB Governing Council raised the three key ECB interest rates by 25 basis points at its monetary policy meeting in June 2023 and did the same at its July meeting. The policy rate increases are a response to the stubborn inflation environment, as reflected in particular by underlying inflation. The key ECB interest rates need to be set at sufficiently restrictive levels for as long as necessary to achieve a timely return of inflation to the 2% medium-term target. Going forward, the ECB Governing Council will continue to follow a data-dependent approach.

… discontinues APP reinvestments

The ECB Governing Council also confirmed in June its announcement from May that it would stop reinvesting the principal payments from maturing securities under the APP as of July 2023. In July, the Governing Council also decided to set the remuneration of minimum reserves at 0% to improve the efficiency of its monetary policy. That decision reduces the total amount of interest payable by the Eurosystem on reserves while preserving the effectiveness of monetary policy.

Supply-side and demand-side factors weakening credit growth in euro area

Monetary growth reduced by investors' portfolio rebalancing and weak lending

As a result of this continued monetary policy tightening and weak economic developments, euro area monetary growth continued to decline in the second quarter of 2023, with the annual rate of the broad monetary aggregate M3 falling to just over ½% at the end of June. This was due, in particular, to the ongoing decline in overnight deposits, which still earn relatively low interest. Given the widening interest rate spread, investors continued to rebalance their portfolios towards higher-yielding forms of investment – and away from M3 as well. On the supply side, the ongoing reduction of the Eurosystem's balance sheet combined with still weak bank lending caused monetary growth to slow. The subdued economic outlook, the associated credit risk and the higher financing costs dampened lending to non-financial corporations and households. According to the latest Bank Lending Survey, in the reporting quarter loan demand fell again while the continued tightening of lending conditions was a factor in weaker credit growth in the euro area.

German economy still experiencing weak spell

German economy lacklustre in Q2

The German economy is still experiencing a period of weakness. According to the Federal Statistical Office's flash estimate, economic output stagnated in the second quarter of 2023, after having contracted in the winter half-year (October-March). Weak foreign demand weighed on industry. Higher financing costs also presented headwinds for the economy. These depressed demand for construction work and capital goods and slowed lending. Loans to households for house purchase, in particular, saw significantly less demand than in previous quarters. However, growth in loans to non-financial corporations also continued to lose momentum in the second quarter. Developments in the real economy could have been even weaker were it not for the still high backlog of orders in parts of industry and construction and abating supply bottlenecks. The sound labour market also acted as a tailwind for the economy. As wages continued to rise steeply and inflation was no longer quite so high, private consumption probably recovered somewhat.

Wages continue to rise steeply

Labour market fairly robust

The labour market is proving fairly robust in the current phase of cyclical weakness. Nevertheless, in the second quarter the previously high pace of employment growth declined markedly, and unemployment saw a moderate uptick. Although labour market tightness eased slightly, there are still a comparatively large number of vacancies given the relatively low unemployment figures. The leading indicators suggest that employment will remain stable in the coming months, with unemployment continuing to rise slightly.

Negotiated wages rose sharply, recent wage agreements contain large increases

Negotiated wages continued to rise sharply in the second quarter of 2023. Growth in actual earnings probably outpaced that of negotiated wages in the second quarter as well. Moreover, the most recent wage agreements were once again generally high. As before, they consist of a combination of significant inflation compensation bonuses and high permanent wage increases. With inflation still high and the labour market remaining fairly tight, high wage settlements are expected in the coming months, too.

Core inflation rate still very high

Inflation stubbornly high in Q2 2023

Consumer prices (as measured by the Harmonised Index of Consumer Prices, or HICP) once again rose sharply in the second quarter. Averaged over April to June 2023, they increased by a seasonally adjusted 1.0%, compared with 0.9% in the first quarter. Looking at the year-on-year figures, the inflation rate fell from 8.8% to 6.9% in the second quarter of 2023. This was mainly because energy prices had risen sharply in the previous year in the wake of the Russian invasion of Ukraine and this base effect has now dissipated. The prices of food and non-energy industrial goods also went up less sharply than in the previous quarter. By contrast, services prices picked up significantly year on year. Accordingly, the core rate, which excludes the volatile components of energy and food, held stubbornly firm at 5.6% in the second quarter, compared with 5.5% in the quarter before.

Inflation rate down slightly in July, likely to subside over rest of the year as well

In July, the inflation rate fell slightly to 6.5%, after having stood at 6.8% in June. The core inflation rate excluding energy and food rose a little, however, to 6.2%. This high figure was partly due to one-off effects from last year's fiscal relief measures and the effect of the increase in the HICP weight for package holidays in 2023. But even without these one-off effects, the core rate is likely to have remained at a very high level of around 5½%. In the coming months, inflation will, as things currently stand, probably come down further, mainly thanks to an increasingly dampening contribution from energy prices. In addition, abating price pres-

sures along supply chains and lapsing one-off effects are likely to play a part in lower inflation. By contrast, wage growth will probably remain strong, even going into the new year. This is a key reason why the inflation rate is likely to stay above 2% for longer. Higher inflation expectations and potentially recurring energy price shocks also pose upside risks to the price outlook.

Economic output expected to more or less stagnate in the third quarter, too

Economic output is likely to more or less stagnate again in the third quarter of 2023

German economic output will probably remain largely unchanged again in the third quarter of 2023. Given stable employment and strong wage growth, as well as declining inflation, the recovery in private consumption is likely to continue. This will also give a boost to the services sector. Some subsectors in industry and construction are continuing to benefit from their large order backlog. Diminishing supply bottlenecks mean that orders can be processed more quickly. However, industrial output looks set to remain weak at first, as foreign demand has been on a downward trend of late. High financing costs will probably continue to weigh on investment. They are also still dampening demand in the construction sector, which is likely to be increasingly reflected in production.

Government deficit decreasing as temporary support measures wind down

General government still running significant deficit in 2023 owing to extensive support measures

The German government will record a significant deficit in 2023, too. This is because it continues to provide extensive crisis-related support to enterprises and households, mainly by using energy price brakes and, in the area of wages, by exempting inflation compensation bonuses from taxes in some cases. Nevertheless, the general government deficit is likely to decline again on the year (2022: 2.7% of GDP). This is because, compared with 2022, temporary support measures are likely to become less significant overall. One major reason for this is the fact that energy prices are lower than expected. As a result, energy subsidies are weighing far less heavily on the government budget than originally anticipated.

Expiring crisis measures will further reduce deficit in 2024; expansionary spending stance in other areas

The deficit is likely to fall again next year as the volume of temporary support measures continues to decrease. However, the rest of the government budget (excluding the temporary support measures) is increasingly moving into deficit. These diverging developments mainly apply to central government (including its special funds), which is funding the lion’s share of the support measures and will thus benefit the most from the easing of this burden. At the same time, its credit-financed expenditure on climate policy and defence is rising sharply. Furthermore, there are signs that state and local government budgets will also be fairly expansionary in the year ahead.

Central government building up large deficits in off-budget entities

Central government continues to apply the debt brake to its core budget, with significant deficits in its off-budget entities

With regard to central government finances, it is not enough to focus solely on net borrowing in the core budget. Although the core budget will again comply with the standard limit under the debt brake as of 2023, it is still showing a large deficit this year, much of which is being financed from the general reserves. The off-budget entities also show significant deficits in the planning period from 2024 to 2027. They are mainly used to finance expenditure on energy and climate policy, as well as defence. To fund its projects here, central government is using reserves from coronavirus emergency loans as well as loans from the Armed Forces Fund. Overall, the structural deficit is likely to be significantly higher than the debt brake ceiling for net borrowing. That said, the plans for the off-budget entities have not been published in full. It is also unclear how central government will cope with the financial challenges

once the scope for deficits in the off-budget entities has been used up. From 2028 onwards, it will also have to make substantial repayments for emergency borrowing and EU debt.

Need for sound fiscal policy in high inflation environment

Given high inflation, it would be prudent not to ease fiscal policy

Given the high level of inflation, it would be prudent from a stability policy perspective not to adopt any further measures that increase the deficit. Otherwise, monetary policy would need to be tightened even more sharply in order to achieve its inflation target. For fiscal policy, this also means, for example, that the funds freed up from energy support measures should not be spent elsewhere. This does not mean neglecting important policy objectives. Rather, they would have to be funded directly – either by lowering expenditure elsewhere or by increasing revenue. This would, for example, allow measures that improve growth conditions to be implemented without stimulating demand through additional deficits.

Effective debt brake ensures sound public finances; …

The binding effect of the debt brake is also strengthened if large-scale expenditure is not funded upfront via the escape clause. Effective fiscal rules ensure sound public finances. And sound public finances are not only important for a stability-oriented monetary policy stance; they also underpin a government's ability to take action.

… stability-oriented reform justifiable

At present, the debt brake is making the borrowing framework relatively restrictive. A reform that moderately raised the regular limits of the debt brake would therefore also be justifiable in the interests of stable public finances. The Bundesbank has made proposals for a stability-oriented reform. For example, the scope for deficits could be extended if the debt ratio is below 60%. If investments are to be prioritised within the prescribed limits, leeway could be reserved for net investment.

Very high debt ratios in some parts of the euro area; binding fiscal rules therefore particularly important

Public finances in some other euro area countries are considerably less favourable than in Germany. At the end of the period under review, the German debt ratio stood at around 66% and, in line with current plans, is gradually falling further towards 60%. By contrast, debt ratios of over 100% are expected for 2023 and beyond in a number of euro area countries including the major economies of Italy, Spain and France. It is crucial that the fiscal rules encourage governments to bring down high debt ratios. For this to happen, the Stability and Growth Pact will have to be more stringent and more binding after the reform. The debate surrounding this reform is still underway. However, the European Commission's current proposal risks failing to meet this objective.