The current economic situation in Germany

Overview

Muted economic activity amid declining but still high inflation

Global economic activity maintains muted upward trend

Global growth muted

It remained a mixed picture for global economic activity in the third quarter. Euro area economic growth continued to be sluggish. By contrast, economic growth in the United States and China picked up significantly, driven mainly by buoyant private consumption. This also boosted global economic growth, albeit probably only temporarily. The tightening of monetary policy in many regions of the world, the high energy prices and the special structural challenges in China continue to be a drag on the global economy.

Signs of "soft landing"

In the third quarter, the global economy benefited from improved industrial performance, in particular. Global industrial output probably rose again markedly following the weak preceding quarter. However, there is still no sign of any sustained improvement in industrial activity. Instead, business surveys are pointing to a drop in new orders and weak demand overall. Looking at the services sector, too, the situation and outlook have recently been assessed as muted in many places. There is no indication of a global recession, though: labour markets remain robust, inflation rates are dropping, and real wages are going back up. On the whole, there are mounting signs of a "soft landing": despite a process of disinflation that is being driven by tighter monetary policy, the global economy is still showing muted growth.

Inflation pressures continuing to ease, but considerable risks to the outlook

Consumer price inflation continuing to ease in advanced economies, but considerable risks

Inflation continued on its gradual downward trajectory. In the group of advanced economies, consumer price inflation had fallen to 3.4% by October. Underlying price pressures likewise eased. The core inflation rate (i.e. excluding energy and food) dropped to 4.1% in October. However, the risks to future consumer price developments remain tilted to the upside. They are emanating, not least, from the persistently high wage growth. In addition, energy markets have once again taken centre stage. The armed conflict in the Middle East has so far had no major impact on crude oil prices. Should the conflict severely impair production in the region, however, prices are likely to rise considerably. Given well-stocked storage facilities and a subdued economic outlook, the risks to the European gas supply appear markedly lower than a year ago. They have not disappeared altogether, though.

International financial markets caught between high inflation and divergent economic prospects

Yields rose in environment shaped by continued high inflation and diverging economic prospects

International financial markets were characterised by continued high but declining inflation rates. In addition, diverging economic prospects in the major currency areas shaped general events in the financial markets. In this environment, central banks in these areas have initially continued to tighten their monetary policy. The US Federal Reserve raised its policy rate by 25 basis points in July, but has left it unchanged since then. After two further interest rate moves of 25 basis points each in July and September, the Governing Council of the ECB also decided at its most recent meeting in October not to raise key interest rates any further for the time being. Overall, however, both central banks stressed the need to leave policy rates at a restrictive level for a sufficiently extended period of time and kept open the option of further policy rate hikes depending on the inflation situation. In this environment, market participants increasingly felt that key interest rates might remain at a restrictive level for an extended period of time. Given robust US economic data and the fact that the labour market had been resilient for months, this market view was particularly pronounced for the Fed's policy rate outlook.

The "higher-for-longer" interest rate scenario initially led to rising nominal and real interest rates in both currency areas. In the euro area, however, the increase in yields was weaker given subdued growth prospects. These developments were reflected in a depreciation of the euro against the US dollar during the third quarter of 2023. Since the end of September, there has also been growing concern among market participants that US fiscal deficits could be higher in the future. This reinforced the rise in yields on US Treasuries, which also spilled over to the euro area through international interest rate linkages, albeit to a somewhat lesser extent. Towards the end of the period under review, there were divergent developments in the financial markets. The tighter financial conditions caused market participants to price higher downside risks to economic activity into their medium-term policy rate outlook. The somewhat weaker US labour market data and the better-than-expected US inflation data have intensified the decline in yields and put pressure on the US dollar since the beginning of November.

Yields on euro area government bonds rose at different rates

The markets for risky asset classes followed the general interest rate trend. Overall, rising real interest rates and diminishing risk appetite on the part of investors have led to valuation losses in some cases. In this environment, yield spreads on the government bond markets, in particular, widened at times. Looking at euro area government bonds, Italian paper experienced spread widening, driven by upwardly revised forecasts of Italy's fiscal deficit. Prices in the equity markets showed little change following temporary, in some cases distinct, losses.

Eurosystem raises key interest rates further

Monetary policy: ECB Governing Council raises key interest rates by 25 basis points in September …

The ECB Governing Council's interest rate increase in September 2023 was based on its updated assessment of the inflation outlook, the underlying inflation dynamics and the strength of monetary policy transmission. Although realised inflation was continuing to decline, inflation was still expected to remain too high for too long. On the basis of its assessment in September, the Governing Council then held that, thanks to the interest rate hikes, the key interest rates had reached levels that would make a substantial contribution to the timely return of inflation to the target. For this to happen, the key interest rate levels would have be maintained for a sufficiently long duration.

… and leaves them unchanged in October

In October 2023, the Governing Council therefore left key interest rates unchanged for the first time since it began raising interest rates in July 2022. Incoming information since the September meeting has broadly confirmed its previous assessment of the medium-term inflation outlook. The Governing Council will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction.

Supply-side and demand-side factors weakening credit dynamics in the euro area

Annual M3 growth becomes negative and lending stagnates

The broad monetary aggregate M3 declined further in the third quarter of 2023, pushing the year-on-year growth rate into negative territory for the first time in the history of monetary union. The steep drop in monetary dynamics reflects how money holding has adapted to the changed interest rate environment: in particular, the persistent rise in interest rates is encouraging the money-holding sectors to shift their relatively low-yielding M3 investments away from M3 and into higher-yielding forms of investment. On the supply side, the ongoing reduction of the Eurosystem's balance sheet combined with stagnant bank lending were a drag on M3 growth. The slowdown in lending was attributable to demand-side and supply-side factors alike: higher financing costs and a gloomier economic outlook dampened the demand for lending on the part of non-financial corporations and households whilst, according to the latest Bank Lending Survey (BLS), banks continued to tighten their lending policies, primarily owing to heightened credit risk.

Economic output in Germany down slightly in the third quarter

German economy still navigating through choppy waters

The German economy is still navigating through choppy waters. Economic output declined slightly in the third quarter of 2023. According to the Federal Statistical Office's flash estimate, real gross domestic product (GDP) was a seasonally adjusted 0.1% lower than in the previous quarter, during which it had increased somewhat, according to revised data.[1] Industry also suffered in the third quarter from weak foreign demand and the fallout from the prior energy price shock. Increased financing costs continued to dampen private investment, thereby also weighing on domestic demand for industrial goods, and, in particular, construction work. Furthermore, the order backlog decreased further, absorbing the decline in demand in both sectors to an ever smaller degree. As a result, output in these areas declined. Real exports of goods also fell. Moreover, private consumption remained lacklustre. Despite strong wage increases, declining inflation rates and stable employment, consumers still held back on additional spending. The services sector, by contrast, proved to be quite robust in this difficult environment.

Lending in Germany tails off further

German banks' lending to domestic private sector tails off further

Lending tailed off further in the third quarter, with loans to non-financial corporations even recording outflows on balance. This was due, for one thing, to the now significantly higher lending rates, the subdued demand for goods and services both from within Germany and abroad and the uncertain economic outlook. For another, the German banks surveyed in the BLS continued to tighten their lending policies, mainly owing to heightened credit risk. Lending to households likewise lost further momentum. High inflation, increased construction prices and the further rise in financing costs, in particular, dampened demand for loans for house purchase. At the same time, BLS banks tightened their credit standards and terms and conditions for loans in this segment, too.

Labour market remains robust

Labour market stable

The robust labour market continued to stabilise economic activity in Germany. Despite the slight decline in economic output, employment in the third quarter remained at the high level recorded in the previous quarter, having risen steeply in the first half of the year. Unemployment increased moderately in the third quarter, but somewhat more sharply in October. The number of vacancies declined slightly, but remained at a high level. This meant that the still very tight situation in the labour market – expressed by the ratio of vacancies to unemployed persons – eased only slightly. No significant decrease in employment is projected for the fourth quarter, either.

At 4.7%, negotiated wages were up even more sharply in the third quarter of 2023 than in the

1 Seasonal adjustment here and in the remainder of this text also includes adjustment for calendar variations, provided they can be verified and quantified. The flash estimate also included revisions for the previous quarters in some cases. Overall, this results in a somewhat higher level of economic activity than previously reported.

Negotiated wages up sharply in Q3; actual earnings up even more sharply

second quarter. As before, high social contribution-exempt inflation compensation bonuses played a key role here. Actual earnings, in turn, are likely to have seen a significantly stronger increase than negotiated wages in the third quarter of 2023. The most recent wage agreements again contained large pay rises for the most part. The trade unions also made high wage demands for the sectors that were in negotiations in the third quarter.

Inflation rate down considerably at the end of the period under review on account of base effects

Inflation rate drops markedly in Q3 2023, partly due to base effects

Consumer prices as measured by the Harmonised Index of Consumer Prices rose somewhat more slowly in the third quarter of 2023 than in the previous quarter. Averaged over July to September 2023, they increased by a seasonally adjusted 0.8% (second quarter: 1.0%). In a year-on-year comparison, the inflation rate was down markedly once again in the third quarter of 2023, from 6.9% to 5.7%. The sharp rise in energy prices in the third quarter of 2022 generated a dampening base effect, because, for the first time, the former was no longer included in the year-on-year rate. By contrast, the core rate (excluding energy and food) even rose slightly to 5.8%, although this was due to one-off effects.

Following a considerable decline in October, inflation rate likely to hover around its current level in coming months

In October, the inflation rate fell considerably once more, to 3.0%. It had already dropped sharply to 4.3% in September, chiefly due to the fact that at the same time the previous year, the fuel rebate and the €9 public transport ticket had come to an end and energy had become significantly more expensive. In October, too, the energy price-related base effect had a dampening impact. As a result, the core rate (excluding energy and food) decreased less sharply, from 4.8% to 4.2%. The rate of inflation is likely to hover around its current level over the next few months. In the case of food and other goods, declining price pressures along supply chains and exerted by commodity prices will probably dampen inflation further. By contrast, the comparatively high upward pressure on prices in the services sector is expected to continue for a while, partly in the context of strong wage growth. In addition, the contribution of the energy component is likely to become positive again over the coming months as the dampening base effects fall away and the carbon price charged on fossil fuels will be raised at the turn of the year. From the current perspective, inflation could temporarily rise above 4% again in December, as the price-lowering Act on Emergency Aid for Natural Gas Heating for End Consumers *(Erdgas-Wärme-Soforthilfegesetz)* adopted at the end of 2022 will now have an increasing base effect.

German economy set to recover only arduously from period of weakness

Economic output likely to decline again slightly in Q4 2023, but could then pick back up somewhat in Q1 2024

The German economy is set to recover only arduously from the period of weakness that has persisted since the outbreak of war against Ukraine. Economic output is likely to once again decline slightly in the fourth quarter of 2023. However, it could then go back up somewhat in the first quarter of 2024. Domestic economic activity is expected to gradually start picking up speed, as households' real net income is anticipated to rise further on the back of high wage rises and easing price pressures. Even if households were to initially hold back on spending for a while longer, rising real net income will probably prompt them to progressively bring their real consumption back up. Industry is still operating under adverse conditions. Weak foreign demand and the consequences of the earlier energy price shock are continuing to curb its output. Moreover, the drawdown of existing order books is probably providing less and less of a boost to output. Yet tentative signs of a slight improvement after the turn of the year are beginning to emerge. For instance, the underlying trend in new orders suggests that foreign demand may have bottomed out. In addition, enterprises' business expectations for the next six months as surveyed by the ifo Institute have recently brightened, albeit only slightly. In the construction sector, however, an improvement in the short term is not yet on the horizon. The rise in financing and construction costs is continuing to weigh heavily on demand for construction services, and output in this sector is expected to decline.

German government finances continue to recover

Government finances continue to recover in 2023 without strain of temporary coronavirus response measures

Government finances are continuing to recover further in 2023. This is a potentially surprising development given that there has been no let-up in burdens stemming from the energy crisis and weak economic growth: the government is still providing substantial assistance to soften the blow of the energy crisis on firms and households. Tax developments are also weak this year, and higher prices are increasingly being reflected in government spending. However, these factors are outweighed by the fact that coronavirus response measures, which were in place last year, now no longer play a role and nominal GDP is continuing to see highly dynamic growth. The deficit ratio and the debt ratio are thus expected to decline further this year (2022: 2½% and 66%, respectively).

Expiring crisis measures reduce deficit further in 2024, but expansionary stance in other areas

Developments next year will also depend on how central and state governments amend their plans following the ruling of the Federal Constitutional Court (see below). As things currently stand, the deficit is expected to continue to decline, as energy price measures are scheduled to expire. As central government finances the lion's share of these measures, it also stands to benefit the most from the decline. However, central government is planning significant additional spending elsewhere, especially in the Climate Fund and the Armed Forces Fund. Moreover, high inflation is set to have a lagged impact on local government budgets. The social security funds could still close the year with a surplus. This is due in part to higher contribution rates for long-term care insurance and probably also for health insurance.

Federal Constitutional Court rules on debt brake

Federal Constitutional Court issues far-reaching ruling on debt brake

In mid-November 2023, the Federal Constitutional Court issued a far-reaching ruling on the debt brake enshrined in Germany's Basic Law. The ruling concerns central government's second supplementary budget for 2021. However, it also establishes general principles and thus has a wider impact on central and state government finances. The ruling underscores the objective of the debt brake, namely to limit government debt, and precludes a broad interpretation of the constitutional requirements. It is now up to fiscal policymakers to adjust their plans with this in mind, in part with a view to eliminating uncertainties as far as possible.

Escape clause may not be used to prefund future budgets

The ruling strengthens the binding effect of the debt brake. To ensure that debt is curbed in line with the constitutional provisions, the Constitutional Court has issued clear rules on the use of the escape clause. These state that legislators may not use the escape clause to prefund future budgets. Yet this does not mean that measures currently planned in this context have to be scrapped. However, it will be necessary to either reprioritise on the expenditure side or make adjustments on the revenue side to balance government expenditure and revenue.

Ruling strengthens binding effect of debt brake

Ultimately, only binding fiscal rules can safeguard sound government finances. Fiscal rules should not be bypassed. This does not preclude a stability-oriented reform of the rules. There would be a case for moderately expanding the regular borrowing framework if the debt ratio is below the Maastricht reference value of 60%. Reform requires a majority large enough to amend the constitution, and if the debt brake were considered too restrictive, this would be the right way forward. By contrast, attempts to water down the debt brake during budget execution are not appropriate. This, in particular, has been made abundantly clear by the Federal Constitutional Court’s ruling.