

# **| The current economic situation in Germany**

## Overview

### Shortages dampen economic upswing and result in stronger price increases

*Significant loss in momentum of economic recovery*

The global economic recovery lost significant momentum in the third quarter. Severe shortages of intermediate goods hindered economic activity in many regions. As the delta variant of the coronavirus spread, pandemic-induced burdens in some countries were also exacerbated again – a situation compounded yet further at times by other inhibiting factors. For instance, economic growth in China also slowed due to problems on the real estate market. In the United States, weather-induced production losses and the expiry of fiscal transfer payments were partly responsible for weaker growth. Recovery in the United Kingdom also continued at a substantially reduced pace. In the euro area, meanwhile, gross domestic product (GDP) saw renewed strong growth, but here, too, the recovery lost significant momentum over the course of the quarter.

*Global industry increasingly suffering from shortage of materials*

The manufacturing sector, above all, suffered from shortages of important primary products. For months, enterprises in all manner of sectors had already been complaining of increasing delivery times. These delays now had an ever-growing impact on downstream production stages. In spite of well-filled order books, global industrial production sank markedly over the course of the third quarter, and global trade remained listless.

*Further rise in global consumer price inflation*

The rise in global consumer price inflation accelerated further over the last few months. One reason for this was that a high demand for fossil fuels was met with low market supply. As a result, market prices increased significantly. Natural gas prices, in particular, reached new record highs. Furthermore, some enterprises in sectors that had been especially hard hit by pandemic-induced restrictions increased their prices substantially. Ultimately, producers seem

to be passing on cost pressures, which have persisted for some time now, to the end customer to an increasing extent. For industrial countries as a whole, consumer price inflation had increased to 4.8% on the year by October (3.4% excluding energy and food.) Further price pass-through to consumers can be expected over the next few months, too, on account of the persistent inflationary pressure on industrial producer prices. However, as supply bottlenecks are gradually overcome, the associated price surges should abate. That said, there is a risk of accelerated price increases becoming entrenched due to higher inflation expectations. Against this backdrop, the first central banks in the industrial countries have initiated a reversal of their very accommodative monetary policy. Many emerging market economies have already been substantially tightening their monetary policy for quite some time.

The international financial markets have been influenced by surprisingly high inflation rates and increasing inflation expectations during the second half of the year to date. Market participants ratcheted up their inflation expectations, primarily for the next two years. Recently, therefore, the market-based expectations of average annual inflation rates for 2022 lay significantly over 2% in many currency areas and at 3% in the euro area. Rising inflation expectations also led to the view that the central banks' monetary policy response would potentially be swifter than previously indicated. Against this backdrop, nominal interest rates rose until the end of October worldwide, chiefly for short-term maturities. The decision of the US Federal Reserve to taper net purchases in several stages had been widely expected. Of late, however, the major central banks have moved to counter expectations of faster monetary policy tightening. This has contributed to declining yields over the entire maturity range in many places. On balance, ten-year government bond yields increased mark-

*Financial markets shaped by high inflation and anticipated monetary policy response*

edly on their end-June levels in the United States and the United Kingdom, while remaining virtually unchanged in the euro area. Overall, yields on bonds of BBB-rated European enterprises rose slightly. On the whole, though, financing terms on the European bond market thus remain very favourable. The stock markets recorded price gains worldwide, boosted by a good reporting season and higher corporate earnings expectations. Market participants' concerns regarding the further course of the pandemic initially took somewhat of a back seat, but have recently returned to the fore. The aforementioned expectations about inflation developments and future monetary policy in the individual currency areas also shaped developments in the foreign exchange markets. On balance, the US dollar appreciated on a broad basis, while the euro depreciated in effective terms.

*Monetary policy: mild reduction in PEPP purchases compared with the preceding two quarters*

In September, the ECB Governing Council judged that favourable financing conditions could be maintained with moderately lower net asset purchases under the pandemic emergency purchase programme (PEPP) than in the previous two quarters. It then confirmed this assessment at its October monetary policy meeting. Net asset purchases will continue with an unchanged anticipated total envelope of €1,850 billion until at least the end of March 2022 and, in any case, until the Governing Council judges that the coronavirus crisis phase is over. If favourable financing conditions can be maintained with smaller asset purchase flows overall, the envelope of €1,850 billion need not be used in full. Equally, the total envelope can also be increased if necessary.

*Gradual normalisation of monetary growth*

The broad monetary aggregate M3 recorded a significant expansion in the third quarter of 2021 as well. However, net inflows remained substantially lower than those seen at the outset of the pandemic, signalling a continued normalisation of monetary growth. On the counterparts side, the Eurosystem's continued asset purchases boosted monetary growth. Banks' domestic lending also saw a significant

increase: for one thing, non-financial corporations' loan demand picked up momentum on the back of their funding needs for investment purposes. For another, household demand for loans for house purchase remained consistently strong. At the same time, the banks participating in the Bank Lending Survey (BLS) reported that they had only tightened their credit standards in the third quarter for loans for house purchase.

German economic activity continued to see a substantial recovery in the third quarter of 2021. According to the Federal Statistical Office's flash estimate, real gross domestic product (GDP) was up 1.8% on the quarter after seasonal adjustment, which is still 1.1% short of its pre-crisis level in the fourth quarter of 2019. This recovery was buoyed by strong growth in the services sector. The easing of measures to protect against the coronavirus in some areas brought about robust catch-up effects, although these waned considerably over the summer months. By contrast, industrial output continued to decline, chiefly due to the worsening shortages in intermediate goods and commodities in the third quarter. Once again, this hit the automotive industry particularly hard. The construction sector also suffered from materials shortages. Furthermore, there was a particularly sharp increase in the extent to which output in this sector was hampered by a lack of labour. Overall, although the economy exited the second quarter with considerable momentum, it is unlikely to have picked up any more speed over the third quarter.

*Steep rise in German economic output in Q3 2021*

On the demand side, private consumption was the main driver of growth for the recovery in the third quarter, just as it had been in the preceding quarter. Strong catch-up effects associated with the easing of most of the containment measures had an impact here in particular. By contrast, investment and exports were severely impaired by supply problems in the industrial sector. Business investment in new machinery and equipment is therefore likely to have gone down significantly. Exports of goods

*Private consumption main driver of growth*

fell considerably despite continuing high demand from abroad. The exports of services, however, are likely to have risen sharply. That said, they constitute only a relatively small share of total German exports.

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

Banks' lending in Germany saw dynamic growth in the third quarter. Lending to households increased once again, which was due to renewed high demand for housing loans boosted by the ongoing exceptionally favourable financing conditions. Credit standards for loans to households for house purchase were tightened slightly in net terms. Loans to non-financial corporations also picked up strongly, especially in the long-term maturity segment. This was mainly thanks to the continued recovery in economic activity associated with an increase in financing needs, especially in domestically oriented sectors such as the construction and real estate sectors.

*Substantial recovery in labour market in Q3, but momentum losing steam recently*

The labour market saw a very substantial recovery in the months of June and July. This momentum lost steam over the third quarter, however, mainly as a result of the sustained supply difficulties in the industrial sector and the fading boost from the easing of pandemic-related restrictions in the services sector. Even so, the level of employment increased quite considerably on the quarter, unemployment fell substantially, and the use of short-time work could be scaled back significantly. Nevertheless, the situation on the labour market is not expected to continue to improve to the same extent over the next few months.

*Negotiated wages up only slightly in Q3, actual earnings continue to rise markedly*

Negotiated wage growth was only modest in the third quarter, driven partly by a baseline effect in the metal and electrical engineering industry. Actual earnings are likely to have risen to a markedly greater extent than negotiated wages over the same period. The main reason for this is the decrease in short-time working. The employees concerned extended their working hours again and thereby saw their earnings rise considerably on the level of the previous year, which had been pushed down

by short-time work. The recovery of the German economy was reflected in the higher volume of new agreements in the third quarter compared with 2020. A role was also played by the influence of higher inflation rates and signs of resurgent labour market tightness. The underlying macroeconomic conditions also point to stronger wage growth for collective wage agreements coming up for renewal.

In the ongoing coalition talks to form a new Federal Government, the idea of raising the minimum wage to €12 by the end of 2022 is being considered. Such a political objective threatens to undermine the independent Minimum Wage Commission. The significant minimum wage increase planned would affect the lower wage brackets markedly and would have non-negligible spillover effects on the wage brackets higher up. It is also likely to amplify wage pressures in future.

Consumer prices saw an exceptionally steep rise in the third quarter of 2021. The Harmonised Index of Consumer Prices (HICP) was up by 1.1% after seasonal adjustment and thus somewhat more strongly than in the preceding quarter. Industrial goods excluding energy in particular became markedly more expensive in light of the exacerbated shortage of materials and further rises in shipping costs. The prices of services were also raised somewhat more sharply than in the second quarter. Significant price adjustments for rental cars, inter alia, played a role in this regard. Yet even services affected by temporary business closures in the first half of the year, such as the catering sector, continued to see distinct mark-ups.

Inflation rates expanded substantially in year-on-year terms. Overall, consumer prices rose by 3.5% in the third quarter, and by 2.1% when energy and food are excluded. On the one hand, headline inflation is likely to have been pushed up by 1¼ percentage points owing to the baseline effect from the VAT rates that had been temporarily lowered in the second half of 2020. On the other hand, the typical seasonal

*Political objective of minimum wage of €12 an hour questionable*

*Another extremely sharp climb in consumer prices in Q3*

*Inflation rate at high level even excluding one-off effects*

high in package holiday prices in the summer – especially in July and August – was much lower than last year because the weighting of package holidays in the HICP fell. This reduced the inflation rate by just over one percentage point. Even without these one-off effects, the headline rate is likely to have stood at almost 3% in the third quarter, and the rate excluding energy and food at around 2%.

*Further substantial rise in October*

Prices saw a further substantial rise in October. Annual headline inflation rose from 4.1% in September to 4.6%. This month it could even reach just under 6% (CPI: just over 5½%), of which just over 1½ percentage points would be attributable to the two one-off effects. The statistical one-off effect is now working in the opposite direction, increasing the inflation rate by just over ¼ percentage point. This effect will come to an end in December, and the VAT base effect will do so in January. The inflation rate should then decline perceptibly, although the bulk of the major increases in market prices for natural gas will probably only be passed on to consumers after the turn of the year. While, as things stand, headline inflation is likely to gradually continue falling in the following months, it could remain significantly above 3% for an extended period of time. It is conceivable that core inflation will be substantially over 2%.

*Economic recovery could see a brief pause in Q4 2021*

Initially, there will probably be a brief pause in the economic recovery. From today's perspective, GDP could broadly stagnate in the final quarter of 2021, after economic output already stopped rising over the course of the third quarter. The surge in growth coming from the services sector has probably largely come to an end for the time being, having mainly been due to a certain degree of normalisation after coronavirus response measures were eased. However, some containment measures have already been tightened again. The industrial sector will probably continue to dampen macroeconomic growth in the fourth quarter. While demand for industrial products remains high, supply problems in the industrial sector are likely to continue weighing on growth. The

construction sector will probably contribute positively to growth despite an increasing shortage of labour in this area, in particular. Throughout the final quarter of 2021 and the first quarter of 2022, developments will be subject to risks associated with an intensification of the pandemic. As things stand, however, the macroeconomic effects will probably be less severe than in previous waves of the pandemic. The exceptionally high order backlogs in industry and construction suggest that substantial backlog and catch-up effects will emerge once supply bottlenecks perceptibly ease.

The coronavirus crisis is still having a key impact on Germany's public finances in 2021. The general government deficit could therefore reach a similar size to that recorded last year (2020: 4.3% of GDP). As central government is shouldering the vast majority of the budgetary burdens caused by the crisis, it will account for most of the deficit. However, the budget outturn stands to be much more favourable than the very high figures projected in the draft budget.

*Coronavirus crisis still having strong negative impact on public finances in 2021*

Next year, government deficits are likely to fall back again sharply as the expected economic recovery will also ease the burden on government budgets. Under the legal status quo, moreover, the coronavirus measures creating these budget pressures will gradually come to an end. Factoring out possible new measures from the incoming Federal Government, the general government deficit ratio could therefore fall back towards 1%. The consolidation required following the crisis would thus be limited and on a much smaller scale than initially expected. According to the latest tax estimate, for example, it is likely that tax revenue will even be above the trajectory projected before the crisis – after adjustment for tax cuts implemented in the meantime.

*Easing in 2022 due to cyclical recovery and expiring measures*

A moderate structural deficit is expected for 2022, following the structural surpluses posted in the pre-crisis years. This reflects the fundamental loosening of the fiscal stance during the

*Fiscal loosening in coronavirus crisis mainly via comparatively high expenditure growth*

coronavirus crisis. Above all, various expenditure categories saw dynamic growth, also in structural terms. This is true of social expenditure in particular, but also of spending in areas such as education, infrastructure and climate policy. The structural expenditure ratio excluding interest expenditure is thus close to historic highs.

*Invoking escape clause in 2022 does not appear warranted*

The outlook for public finances depends, not least, on the fiscal policy of the incoming Federal Government. The incumbent government was intending to invoke the debt brake escape clause again in 2022. There are currently no signs that the new government will do otherwise. However, there is good reason to believe that 2022 will not be a crisis year. This means that there should be comparatively little need for pandemic-related government expenditure. Moreover, there is a general expectation – also reflected in the latest government estimate – of normal economic conditions. After adjustment for changes in tax law (the majority of which were already planned before the crisis), tax revenue is exceeding pre-crisis expectations. All in all, invoking the escape clause does not appear warranted as things stand. At all events, it would be extremely difficult to justify financing non-crisis-related budgetary burdens through borrowing made possible by the escape clause.

*Social security funds: fundamental need for action*

Fundamental financing pressures are building up in the health, pension and long-term care insurance schemes. Their expenditure is tend-

ing to grow faster than their revenue base. To alleviate these pressures, slower spending growth, higher contribution rates and/or permanent increases in grants from central government are needed. So far, there is no indication that the incoming Federal Government will tackle the expenditure issue. There is probably no leeway in the central government budget for additional grants without budget-alleviating measures elsewhere. Significant rises in contribution rates would therefore appear likely.

Central and state government finances are bound by the debt brake. In addition, they are jointly responsible for complying with the European fiscal rules. Some consider the fiscal rules to be overly strict, and reforms are being discussed. Another current debate in Germany centres on how to formally fund certain projects beyond the reach of the debt brake via off-budget constructs. This threatens to at least partially undermine the restrictions on government borrowing. Moreover, Germany's effective compliance with the European rules might no longer be ensured by the debt brake. The debt brake has proved its worth so far, and adjustments do not appear urgently necessary. If changes are considered appropriate, these should be discussed openly and, where necessary, given a new legal grounding. The rules would need to remain binding, and sound public finances still ensured. That would, in any case, be preferable to hollowing out and circumventing the debt brake.

*Binding fiscal rules important*