The current economic situation in Germany

Overview

Stronger global inflation triggers shift in monetary policy stance

Global economy probably regained some momentum in Q4

Global economic growth is likely to have picked up again somewhat in the final quarter of 2021. However, economic developments were quite varied from region to region. In the United States, real gross domestic product saw a return to strong growth due to factors limiting production easing off to a certain extent and COVID-19 cases tailing off. In China, the normalisation of the power supply contributed to more dynamic growth. In the euro area, meanwhile, the upswing was significantly weakened as containment measures were tightened and consumer behaviour became more cautious once again.

Marked recovery in industry; temporarily increased burdens on service providers

The acceleration of global economic growth was attributable not least to industry, and in Germany, specifically to car manufacturers. The worldwide shortage of highly sought-after semiconductor components persisted. That said, the situation eased somewhat with the recovery of production in South-East Asia. This had been restricted for some time due to the pandemic. Amid the rapid spread of the Omicron variant, there is currently a risk of supply-side obstacles becoming worse again. However, the consequences of the spread of this variant will probably be significantly less disruptive to high-contact service sectors than was the case with previous waves of infection. Containment measures have generally been tightened to no more than a moderate degree, or have even been relaxed most recently due to the fact that, in many places, the virus variant is infecting largely vaccinated populations and fewer infected people are becoming severely ill. However, the high case numbers mean that more people are required to isolate or quarantine, hampering economic activity. Even so, judging by the experiences of other countries, the Omicron wave could subside quickly, meaning that the burdens it brings with it are likely to be quite short-lived.

Further rise in crude oil prices; gas prices persistently high

In view of the improved demand outlook and a strained supply situation, crude oil prices have risen considerably of late. Gas prices in Europe dipped slightly at the start of January after having reached record highs in December 2021. Due to the protracted political crisis between Russia and Ukraine, however, the cost of future gas flows became significantly more expensive, and futures suggest that gas prices will stay high for the remainder of the year.

Renewed rise in consumer price inflation in industrial countries; central banks signal policy tightening

High energy prices made a substantial contribution to the renewed rise in global consumer price inflation. According to an initial estimate, the year-on-year rate of change up to January in consumer prices for the industrial countries as a whole rose to 5.8%. But even defined more narrowly, i.e. excluding energy and food, the inflation rate climbed to 4.3%, which is indicative of broader-based inflation. This development was driven by buoyant demand coupled with high cost pressures initially resulting chiefly from price increases at upstream production stages and for transport services. Moreover, some industrial countries were already experiencing accelerated wage growth. Against this backdrop, many central banks tightened their monetary policy stance or at least considered doing so.

Financial markets shaped by mounting inflationary risks and expectations of tightened monetary policy

Mounting inflationary risks also shaped developments in the international financial markets. Market participants on both sides of the Atlantic revised their inflation expectations for the current and coming year upwards multiple times. Together with the assessment that the burdens resulting from the Omicron variant would be manageable, this led to some central banks making their monetary policy less accommodative. The Bank of England, for instance, responded with two Bank Rate increases, while the Fed announced in January

that it deemed it appropriate to bring net asset purchases to an end in March and to raise the federal funds rate soon. Market participants are now anticipating a less expansionary monetary policy for the euro area going forward, too. As a result, benchmark returns have increased and real interest rates have also risen. On the whole, yields on euro area corporate bonds went up significantly more strongly still than government bond yields. On balance, then, the yield spreads of corporate bonds, which are an indicator of enterprises' funding conditions, were most recently slightly above their five-year average. Amid rising interest rates, prices on the international equity markets declined, but they were predominantly in positive territory compared with the end of September. This was due, first and foremost, to an improvement in overall earnings expectations, particularly on the back of increased profit margins at large enterprises. Foreign exchange market developments were also influenced largely by the persistently high inflation rates worldwide, the measures announced by central banks to counteract these as well as those already taken, and speculation among market participants regarding further steps towards monetary policy normalisation. Measured as a weighted average against the currencies of 19 major trading partners, the euro has, on balance, depreciated by 2.1% net since the end of September.

ECB Governing Council decides to end net asset purchases under PEPP

In December 2021, the ECB Governing Council decided on a step-by-step reduction in the pace of asset purchases, whereby net asset purchases under the pandemic emergency purchase programme (PEPP) would be reduced in the first quarter of 2022 and discontinued at the end of March. At the same time, the Governing Council extended the reinvestment horizon for the PEPP to at least the end of 2024. Furthermore, it decided to conduct larger net asset purchases on a temporary basis under the asset purchase programme (APP) as of April 2022. These are set at €40 billion per month in the second quarter and €30 billion in the third quarter, before being maintained at their previous monthly pace of €20 billion from October 2022 onwards.

ECB Governing Council sees risks to inflation outlook tilted to upside

In February 2022, the Governing Council confirmed the decisions it had made in December. However, it also made various changes to its communication. For instance, the need for monetary policy accommodation was no longer mentioned, nor was inflation projected to settle below its target. Instead, the Governing Council stressed that inflation had risen steeply over the last few months and had also been higher than expected in January. In contrast to December, it explicitly spoke of risks to the inflation outlook being tilted to the upside, particularly in the short term. Furthermore, the Governing Council's monetary policy communication no longer ruled out an initial interest rate increase as early as this year.

Money market forward rates rise sharply once again

This adjustment to the Governing Council's monetary policy communication contributed to a further rise in money market forward rates. Using these rates as a basis, it appears that market participants most recently priced in an initial interest rate hike of 10 basis points for as early as July 2022. In addition, the futures curve became far steeper, meaning that a more immediate impact of interest rate increases is also priced in. Although it can be assumed that the rise in forward rates is in large part attributable to risk premia and not to anticipated higher interest rates, market participants will probably expect interest rates to rise far earlier than they had predicted back in December. This was also backed up by the Eurosystem's monetary policy survey conducted prior to the February meeting (Survey of Monetary Analysts). Compared with the December survey, respondents' predictions of when the first interest rate hike would take place moved forwards again.

Further normalisation of monetary growth

The broad monetary aggregate M3 expanded significantly in the fourth quarter of 2021 as well. However, net inflows remained markedly below the high levels that were recorded in the previous year owing to the coronavirus pandemic. Monetary growth thus continued to

normalise. Besides the Eurosystem's ongoing asset purchases, monetary growth was mainly supported by banks' lending to the domestic private sector. Looking at loans to non-financial corporations, the special conditions applicable under TLTRO-III, which are linked to a lending benchmark, resulted in considerable frontloading effects in the final quarter. At the same time, household demand for loans for house purchase remained strong. The banks responding to the Bank Lending Survey (BLS) reported that they had left credit standards for loans to enterprises and loans to households for house purchase broadly unchanged in the fourth quarter.

Distinct decline in German economic output towards end of year

Economic activity in Germany declined markedly in the fourth quarter of 2021, having shown strong growth in the third quarter. According to the Federal Statistical Office's flash estimate, real gross domestic product (GDP) shrank by 0.7% on the quarter after seasonal adjustment. It was thus still 1.5% short of its pre-crisis level recorded in the fourth quarter of 2019. Real GDP grew by 2.8% in 2021 as a whole, having fallen in 2020 as a result of the pandemic.

Resurgence of pandemic depressed services sector and private consumption; industrial production and exports up despite ongoing issue of serious supply bottlenecks

The decline in economic output in the fourth quarter of 2021 was largely due to the resurgence of the pandemic. The resulting containment measures and social and physical distancing requirements hit some services sectors hard. In addition, it appears that activity in the construction sector remained lacklustre in spite of high demand. The construction sector is experiencing a lack of labour and a major – albeit decreasing – materials shortage. By contrast, industry made a positive contribution. In the first three quarters of 2021, growing bottlenecks in the supply of intermediate goods had seen industrial production decline despite order books being very well filled. Although surveys indicated that enterprises still considered the supply problems to be severe in the fourth quarter, the increase in industrial production suggests that they eased to a certain extent. On the expenditure side of GDP, one particular way in which the resurgence of the pandemic was reflected was a clear decline in private consumption. By contrast, investment in machinery and equipment as well as exports probably rose on the back of the positive developments.

Strong uptick in German banks' lending to domestic private sector

In line with these developments, German banks substantially expanded their lending to the domestic private sector in the fourth quarter. Loans to non-financial corporations saw particularly strong growth, especially in the short-term segment. First, this was because banks upped their lending in order to qualify for the more favourable interest rate on their TLTRO-III operations. Second, production delays caused by aggregate supply bottlenecks increased enterprises' short-term financing needs. Lending to households rose sharply, too. This was due to constantly high net inflows to loans for house purchase, demand for which was bolstered by the still exceptionally favourable financing terms. Banks tightened their credit standards for loans to households for house purchase again marginally in net terms.

Labour market recovery continued in Q4

The factors that curbed economic activity in the fourth quarter had barely any impact on the labour market. Employment continued to recover, and both unemployment and the use of short-time working arrangements fell substantially. Leading indicators suggest only a comparatively mild dip in the labour market in the first quarter of 2022, despite the currently high infection rates.

Negotiated wages rose more sharply in Q4 than in Q3; actual earnings probably up again considerably

With a year-on-year increase of 1.5%, negotiated wages climbed more sharply in the fourth quarter of 2021 than in the third quarter. In line with the distinct drop-off in short-time working, actual earnings probably rose by considerably more than negotiated wages. At just 1.5% in 2021 as a whole, negotiated wages rose significantly less sharply than in the year before, chiefly owing to wage agreements being modest as a result of the pandemic.

Small 2022 wage round in an environment of high inflation rates

This year, the rise in negotiated wage rates will still be largely influenced by the wage agreements concluded in previous years. At the time the agreements were made, there was a great deal of uncertainty surrounding the economic outlook and inflation rates were low. In this year's small wage round for roughly 8 million employees, the favourable macroeconomic outlook, increasing labour market shortages and high inflation rates could contribute to distinctly higher wage agreements.

Planned increase of general minimum wage to €12 per hour raises pressure on aggregate wages

The Federal Labour Minister is aiming to increase the statutory general minimum wage to €12 per hour from 1 October 2022. This political intervention in the wage-setting process would raise pay distinctly in the lower wage brackets as well as having a marked impact on the wage brackets above, thus presumably increasing upward pressure on aggregate wages. Based on historical relationships, the macroeconomic effects will probably be manageable. However, in the current environment of very high interest rates, a potentially stronger pass-through of wages to prices cannot be ruled out.

Inflation rate hit record level at end of 2021

Consumer price inflation continued to rise in the final quarter of 2021. On average between October and December, the Harmonised Index of Consumer Prices (HICP) went up by 1.2% on the quarter in seasonally adjusted terms. The higher inflation rate was chiefly due to energy prices, which increased even more sharply than before. Growth in prices for food, services and non-energy industrial goods remained strong, but was slightly down on the previous quarter. HICP inflation was up very significantly by 5.4% on the year, following an increase of 3.5% in the third quarter. Excluding energy and food, the inflation rate grew from 2.1% to 3.6%, thus also reaching its highest level since the euro area was established.

On an annual average, consumer prices up very considerably in 2021

At 3.2%, average consumer price inflation for 2021 increased very considerably on the year. First, the base effect of the temporary reduction in VAT rates in the second half of 2020 significantly increased inflation rates in the corresponding period of 2021, and second, energy prices picked up substantially over the course of the year. Non-energy industrial goods and services inflation rose unexpectedly sharply, especially from mid-year onwards. This was due to high price pressures on upstream stages of the supply chain resulting from pandemic-related supply bottlenecks, increased transport costs and higher commodity prices. Given the level of demand, these were passed through to consumers.

High price increases continued on a broad front in January

At the beginning of 2022, the pace of growth in consumer prices increased substantially once again. Energy prices, in particular, picked up sharply owing to considerable price hikes for gas and electricity, though prices of other HICP components also continued to rise on a broad basis. Therefore, despite the elimination of the VAT base effect, in a year-on-year comparison the inflation rate declined to only a comparatively small extent from 5.7% in December to 5.1% in January. In the coming months, inflationary pressures are likely to remain high, given the considerable price increases in upstream stages of the supply chain and persistent demand.

Economic output likely to decline again markedly in Q1 2022 before strongly rebounding in Q2

German economic output is likely to decline again markedly in the first quarter of 2022. This is due to the resurgence of the pandemic caused by the Omicron variant. In contrast to previous waves of the pandemic, the services sector is unlikely to be the only one in which activity is being adversely affected by containment measures and social and physical distancing requirements. In fact, working hours lost due to the pandemic could also be having a distinctly dampening effect on economic output – and in other sectors, too. Nevertheless, positive effects are expected from the industrial sector. Here there are signs of a further easing of supply bottlenecks, and demand for industrial products remains high. In light of very robust demand, GDP is likely to rebound strongly in the second quarter, provided the pandemic subsides and the supply bottlenecks continue to ease.

Government finances provided strong suport to economy again in 2021; deficit again high

Last year, government finances continued to make a considerable contribution to supporting the economy during the coronavirus crisis. This was reflected above all in high expenditure, for example for transfers to enterprises and short-time working benefits. Revenue made a strong recovery, with taxes even surpassing the level that had been expected for 2021 prior to the crisis, after factoring out legislative changes implemented in the meantime. According to initial data, the deficit again amounted to just over 4% of GDP (2020: 4.3%). The debt ratio is likely to have been in the region of 70% at the end of 2021.

Deficit likely to decline significantly in 2022; government budget looks set to weather crisis well

Government finances look set to improve significantly this year. The main reason for this is the economic recovery, which should be accompanied by government economic support coming to an end. The deficit will then go back down and the debt ratio will see a decrease owing to nominal GDP growth in the ratio's denominator. It is thus likely that the government budget will weather the coronavirus crisis well. While the deficits are high for a time, this is largely due to temporary crisis-related burdens that will subside again rather quickly.

Flexible handling of debt brake considerably expands leeway for borrowing and …

The vast majority of crisis-related burdens fall under the central government budget. The debt brake's escape clause, which is designed for use in such an emergency situation, was therefore activated for the central government budget in 2020 and 2021. In these crisis years, the deficits of the core budget amounted to nearly €350 billion in total. However, this high figure far exceeds the coronavirus-related burdens in the core budget. This is because the deficits include nearly €100 billion (2½% of GDP) in exceptional loan authorisations that were not needed and that the central government has placed in its special funds. The second 2021 supplementary budget agreed in January 2022 alone accounts for €60 billion of this amount. In January, the Bundestag also decided to exempt central government's special funds from the debt brake going forward. It is only through this measure that the authorisations contained in the special funds can be used to temporarily expand the leeway for borrowing even after the end of the pandemic emergency. These funds have been earmarked for expenditure that is not closely connected to the pandemic response.

… threatens binding effect of debt brake

As a result, beyond the pandemic emergency and over and above the regular debt brake limit, there is considerable additional scope for borrowing in the upcoming financial planning period. The repayment burdens associated with this are to be deferred until the period after 2027. In these later years, there will therefore be less financial leeway. All in all, the way the debt brake is being used does not appear to be in the spirit of its intention. This could potentially weaken the binding effect of the debt brake. Yet this binding effect is crucial if the debt brake is to reliably ensure sound government finances. There may be arguments for modifying the debt brake's design. Indeed, moderate deficits certainly pose no threat to the soundness of government finances, and the requirements of the debt brake are also sometimes stricter than what is prescribed under the EU a new design rules. If a new design were to take these factors into account, a transparent and stability-oriented reform of the debt brake would be the more suitable path to take.

Greater binding effect of European fiscal rules desirable

A stable monetary union also depends on sound government finances. This means that effective fiscal rules are important at the European level, too. They need to have the effect of reliably lowering high debt ratios. The European rules have thus far not fulfilled this task, which means there is certainly room for improvement here. In particular, the quantitative requirements for the medium-term budgetary objective should be clearer and more binding. Even then, a stabilising and future-oriented fiscal policy would still be a possibility. Improvements in this regard would include, for example, national bad weather funds that are built up when times are good and a capped golden rule that protects government investment expenditure to an extent that it is consistent with stability.