Overview

Continued disinflation amid weak economic activity

Moderate growth in global economy given pronounced regional and sectoral differences

Moderate global growth

The global economy saw moderate growth in the final quarter of 2023, with regional differences in global activity persisting. In the euro area, economic output stagnated. In China, too, growth remained subdued in view of the ongoing downturn in the real estate market. By contrast, the US economy continued to expand at a brisk pace. Overall, the global economy remained solid in spite of strains such as the still relatively high energy and food prices, the tightening of monetary policy in many regions, heightened geopolitical risks and a variety of structural challenges.

Weak industrial activity in advanced economies

Global industrial output increased moderately in the fourth quarter of 2023, again driven by the emerging market economies. In the advanced economies, by contrast, output has been falling on a trend basis for more than a year, with weak industrial activity in the euro area being a key factor. Imports of goods by advanced economies declined even more sharply. According to business surveys, 2024, too, got off to a subdued start in the industrial sector and global trade. The services sector, on the other hand, appears to be gaining momentum.

Decline in inflation decelerating; risks still tilted to the upside

Mixed commodity prices of late; consumer price inflation weakens further

Energy commodity prices have seen mixed growth of late. European gas prices fell significantly against the backdrop of persistently weak euro area industrial activity, the at times mild winter temperatures and stable gas imports. Over the same period, crude oil prices rose slightly. Concerns surrounding a further escalation of the conflicts in the Middle East bolstered price developments. Recently, inflation has eased somewhat more slowly. In the group of advanced economies, the annual growth rate of consumer prices fell to 3.1% in January, and the core rate excluding energy and food sank to 3.8%. Risks with regard to future consumer price developments are likely to remain tilted to the upside for the most part. Should the conflicts in the Middle East spread to oil-producing countries, this would drive energy and consumer prices back up. Moreover, the tight labour markets in many areas and persistently high wage growth could jeopardise the continuation of the disinflationary process.

Market participants anticipating earlier and sharper key interest rate cuts

Expectations of declining inflation and sharper key interest rate cuts weighing on yields

Activity in the international financial markets was shaped by greater confidence among market players that inflation in 2024 could globally recede faster than previously anticipated. In November and December 2023, they gradually revised their previous assessment that key interest rates in many currency areas, such as the United States and the euro area, would remain at high levels for an extended period of time (higher-for-longer interest rate scenario), and instead assumed earlier and sharper key interest rate cuts. Market participants’ adjustment of their expectations was mainly driven by a significant fall in energy prices and by their hopes that disinflation would progress more rapidly than previously expected. The US Federal Reserve also sent early signals that it would probably be able to lower policy rates in 2024. For instance, following the Federal Open Market Committee (FOMC) meeting in December, Fed Chair Jerome Powell expressed the view

that interest rates in the United States had probably reached their peak, and that key interest rate cuts could follow in 2024. This contributed to an appreciation of the euro against the US dollar. US inflation was slightly higher than anticipated in January, causing these expectations that key interest rates would come back down soon to weaken somewhat. In light of the continued robustness of US macro data emanating in particular from the labour market in the new year, however, investors' confidence in a soft landing for the US economy in the event of a decline in inflation increased overall. In the euro area, some members of the ECB Governing Council indicated that they regard a key interest rate cut in summer as conceivable. Against this backdrop, market participants anticipated distinctly earlier and sharper key interest rate cuts than previously assumed, given the more optimistic inflation expectations and the relatively subdued European economic outlook. Both currency areas saw a significant decline in long-term nominal and real interest rates in this setting: a development which, coupled with a sustained robust risk appetite on the part of market players, resulted in significant price gains for risky assets.

Eurosystem leaves key interest rates unchanged

Monetary policy: ECB Governing Council leaves key interest rates unchanged …

At its monetary policy meetings in December 2023 and January 2024, the Governing Council of the ECB left its three key interest rates unchanged. According to the Eurosystem staff's December projections for the euro area, inflation is expected to decline gradually over the course of 2024 before approaching the 2% target in 2025. In January, the Governing Council noted that the incoming data since December broadly confirmed this expectation. Overall, on the basis of its December and January assessments, it continued to hold that 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, though, the key interest rate levels would have be maintained for a sufficiently long duration.

… and announces earlier end to PEPP reinvestments

In December 2023, the Governing Council also decided to advance the normalisation of the Eurosystem's balance sheet. It intends to continue to reinvest, in full, the principal payments from maturing securities purchased under the pandemic emergency purchase programme (PEPP) during the first half of 2024. Over the second half of the year, it plans to reduce the PEPP portfolio by €7.5 billion per month on average, and to fully discontinue the reinvestment of redemptions by the end of 2024.

Recovery in demand for short-term loans in the euro area signals turning point in credit growth

Annual M3 growth becomes positive again and lending recovers

In the final quarter of 2023, the broad monetary aggregate M3 recorded growth for the first time in five quarters. In view of the persistently low interest rate on overnight deposits, the money-holding sectors continued to shift funds into higher-yielding forms of investment. In contrast to the previous quarters, however, funds were still being channelled into higher-yielding M3 holdings purely through the shifting of financial assets in the fourth quarter of 2023, which had a positive impact on monetary growth. On the output side, a marked recovery in lending to the domestic private sector and a significant increase in the net external assets of monetary financial institutions contributed to the increase in monetary growth. The anticipated end of the monetary policy tightening cycle and the expectation of falling lending rates boosted non-financial corporations' demand for short-term loans, in particular. At the same time, those banks participating in the latest round of the Bank Lending Survey (BLS) reported that they had barely tightened their lending policies any further in the final quarter of 2023.

Lending in Germany weakened further

German banks' lending to domestic private sector weakens further

In Germany, by contrast, lending to the domestic non-financial private sector weakened further in the fourth quarter. Lending to non-financial corporations stagnated. Two factors were behind this. First, there were the relatively high funding costs, which, together with subdued industrial and construction activity and the uncertain economic outlook, dampened demand for credit. The second was that the banks surveyed in the BLS once again tightened their lending policies, mainly owing to increased credit risk in light of the subdued economic situation and outlook in addition to sector-specific and firm-specific factors. Lending to households also continued to lose momentum. It was higher construction prices and high funding costs in particular which dampened demand for bank loans.

German economic output down in Q4 2023

German GDP shrinks in Q4 2023

German economic output shrank in the fourth quarter of 2023. According to the Federal Statistical Office's flash estimate, real gross domestic product (GDP) fell by a seasonally adjusted 0.3% on the quarter after virtually stagnating in the first three quarters.[1] Industry continued to be impacted by weak foreign demand. The rise in funding costs remained a drag on investment and thus on domestic demand for industrial goods and construction services. Moreover, uncertainty regarding climate and transformation policy is likely to have dampened investment. In addition, inclement weather constrained construction activity. Further pressure was placed on economic activity by the relatively high sickness rate. By contrast, lower inflation, the robust labour market and strong wage growth supported real private consumption. However, consumers probably remained cautious in their expenditure.

Labour market remains robust

Employment and unemployment both up slightly in Q4

The protracted economic downturn has had only a mild impact on the labour market so far. Despite a decline in economic output, employment increased slightly in the fourth quarter. Whilst unemployment reached a somewhat higher level than in the third quarter, the increase likely came to an end in the past two months. The number of job vacancies also stabilised recently, following an earlier decline. The same applies to most leading labour market indicators. Thus, there are no signs that the weak economy will cause the labour market to worsen significantly. Nor are there any indications of a sustained rise in employment and a concomitant decline in unemployment, which has recently slightly increased.

Weaker rise in negotiated wages in Q4; strong rise in actual earnings

At 3.6% in the fourth quarter of 2023, negotiated wages temporarily rose less sharply than in the third quarter, in which they were up by 4.7%. As in the first three quarters of 2023, large tax and social contribution-exempt inflation compensation bonuses played a key role. All in all, the pay round settlements that have been concluded thus far envisage robust wage increases for 2024 and 2025. The sharp increase in actual earnings in the previous ten quarters continued and is likely once again to have significantly exceeded the increase in negotiated wages in the fourth quarter of 2023. Trade unions' wage demands remain very high, likely partly due to previous real wage losses.

Continued disinflation

Disinflation continued in Q4 2023

For the first time since the end of 2020, consumer price inflation (HICP) was only marginal in the fourth quarter of 2023. On average across the months of October to December 2023, consumer prices increased by only a seasonally adjusted 0.2%, compared with +0.7%

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 some revisions for previous quarters.

in the previous quarter. This disinflation was also clear in the year-on-year comparison, in which the headline inflation rate fell to 3.0% from a level of 5.7% in the preceding quarter. The sharp rise in energy prices in the last quarter of 2022 had a dampening effect here. The core inflation rate (HICP excluding energy and food) also dropped steeply from 5.8% to 3.6%.

Inflation fell slightly further in January; core rate unchanged

The HICP rate dropped markedly in January as well, from 3.8% to 3.1%. This was mainly due to the elimination of the base effect from the 2022 price-lowering Emergency Aid for Natural Gas Heating for End Consumers *(Erdgas-Wärme-Soforthilfe)*, which had temporarily significantly increased the December rate. By contrast, the core inflation rate held steady at 3.4%. The inflation rate may well trend down further in the next few months. In some cases, strong fluctuations in the year-on-year rate are to be expected. This will also be due to some base effects from energy and local public transport. The main factor behind the disinflation process is the declining price dynamics in food and industrial goods. Here, weakening inflation has an impact on upstream stages. By contrast, price pressures in the services sector are likely to ease much more slowly in the coming months, partly because wage growth remains strong.

No recovery in the German economy yet

Economic output may contract once again in Q1 2024

Some stress factors are likely to remain relevant in the first quarter of 2024. Foreign industrial demand recently trended significantly downward. Consumers are likely to remain cautious in their spending. Higher funding costs may constrain domestic investment. Additionally, uncertainty regarding climate and transformation policy remains elevated. Furthermore, effects on production resulting from various strikes – including the rail and aviation strikes – cannot be ruled out. There are still orders on hand in industry and construction. However, they are dwindling. Economic output is thus likely to once again decline slightly in the first quarter of 2024. This second consecutive decline in economic output would put the German economy into a technical recession. While this would mean the ongoing period of weakness in the German economy following the start of the Russian war of aggression against Ukraine would continue, there is still no evidence of a recession in the sense of a persistent, broad-based and distinct drop in economic activity, nor is such a recession currently on the cards. In particular, the income situation and thus household consumption are likely to continue to improve in the future given the stable labour market, sharply rising wages and the declining inflation rate.

Public finances improved in 2023

Public finances improved in 2023 as costs related to the COVID-19 pandemic ended and nominal GDP growth depressed the debt ratio

Germany’s public finances improved last year. The deficit and debt ratios continued to decline and were moderate by EU standards. This was not due to a policy of austerity, however. In fact, the deficit fell (to 2% of GDP) because temporary measures to contain the COVID-19 pandemic were no longer necessary and were allowed to lapse. By contrast, support measures relating to the energy crisis burdened public coffers slightly more than in 2022. Weak growth in tax revenues and higher interest and military spending also drove up the deficit. The debt ratio declined to just under 65% at the end of the third quarter because price developments meant that nominal GDP continued to outpace debt.

Deficit set to shrink further in 2024 absent major consolidation

The deficit looks set to shrink further this year. This is because most of the support measures relating to the energy crisis have been allowed to lapse. Apart from this, however, fiscal policy looks set to become easier. In some areas, ex-

Deficit set to shrink further in 2024 as most support measures relating to the energy crisis are allowed to lapse – otherwise, fiscal policy likely to be easier

penditure is increasing, especially in the Federal Armed Forces and Germany's Climate Change and Transformation Fund. State and local government are experiencing significant growth in staff expenses, amongst other things, owing mainly to higher wages. Spending by social security funds is also growing dynamically. However, this is largely being offset by higher contribution rates to the public long-term care and health insurance schemes.

Central government will no longer make use of the escape clause in 2024 but will still run large deficits

In its 2024 budget plan, central government will, after four years, no longer make use of the debt brake escape clause. Nonetheless, it will still run large deficits; these deficits add up to just over €100 billion in the plans for central government and its off-budget entities. One-fifth of this total (€20 billion) is attributable to the Federal Armed Forces Fund, which is exempted from the debt brake. The debt brake allows cyclical deficits, deficits for the acquisition of financial assets (e.g. generational capital) and a structural deficit of 0.35% of GDP to be financed using net borrowing. These items add up to an additional two-fifths of the planned deficit. Central government will cover the remaining two-fifths using reserves.

Course virtually unchanged in 2024, resulting in considerable pressure in 2025

As compared with the first government drafts, there is a marked reduction in the deficit essentially only in terms of the support measures in relation to the energy crisis. The large deficit earmarked for the Climate and Transformation Fund remains virtually unchanged, although the Federal Constitutional Court ruling reduced the reserve by €60 billion. Overall, however, this will leave hardly any reserves on the books in 2025 for the area of relevance to the debt brake. Adjustments will consequently have to be made next year.

Effective debt brake important

Debt brake intended to ensure sound public finances – which does not preclude stability-oriented reform

Such adjustments will require difficult decisions to be made. New priorities will have to be set on the expenditure side or the revenue side will have to be adjusted. Effective fiscal rules are especially important in such situations in order to ensure sound public finances. This does not preclude a stability-oriented reform. The Bundesbank made its own proposals for the German debt brake in the spring of 2022, and the basic considerations at that time still apply: the German budget ceilings should ensure that the debt ratio generally complies with the 60% reference value and returns to it quickly following a breach. The currently applicable borrowing limit for central government can be relaxed somewhat given this objective as long as the ceiling is not watered down in its application. In this context, it is also possible to earmark parts of the borrowing facilities for certain government expenditure items. This could be done, for example, using a capped golden rule, as discussed by the Bundesbank: up to a fixed ceiling, government net investment can be financed by borrowing. A special fund with its own credit limit in Germany's Basic Law *(Grundgesetz)* could be designed in such a way that it extends the leeway for a deficit in a comparable way; it would therefore not contradict these basic considerations.

EU rules should be applied in such a way that high debt ratios fall rapidly

Implementation crucial for EU rules

The EU's budgetary rules, which Germany must likewise comply with, are being reformed. As things currently stand, it looks as though the reform will further expand discretionary scope in decision-making and application. Its implementation will therefore be crucial. A welcome aspect is that important fiscal anchors will remain in place. Specifically, the reference values of 3% for the deficit ratio and 60% for the debt ratio will continue to apply. And the deficit targets for a Member State are significantly stricter if it fails to meet a reference value. However, a number of aspects are problematic. This includes the fact that these budgetary limits for several years depend, not least, on assumptions which the European Commission arranges in negotiations with the respective

Member State. At the same time, the rules are very complicated. They are likely to be very difficult to understand, both in abstract terms and in their concrete application. It is therefore to be feared that the interested public will be lost as an important pillar of oversight. In addition, the rules will start off with watered-down requirements during a transitional period. During this period, currently high debt ratios could become further entrenched or even rise. Overall, there is a danger that the new rules will make little contribution to the objective of sound public finances as there is much leeway in how they are implemented. This makes it all the more important that the European Commission and ECOFIN translate the rules into ambitious requirements and press for Member State compliance. Such strict application of the rules would, not least, strengthen capital markets' confidence in highly indebted euro area countries.