Recovery in the stranglehold of war

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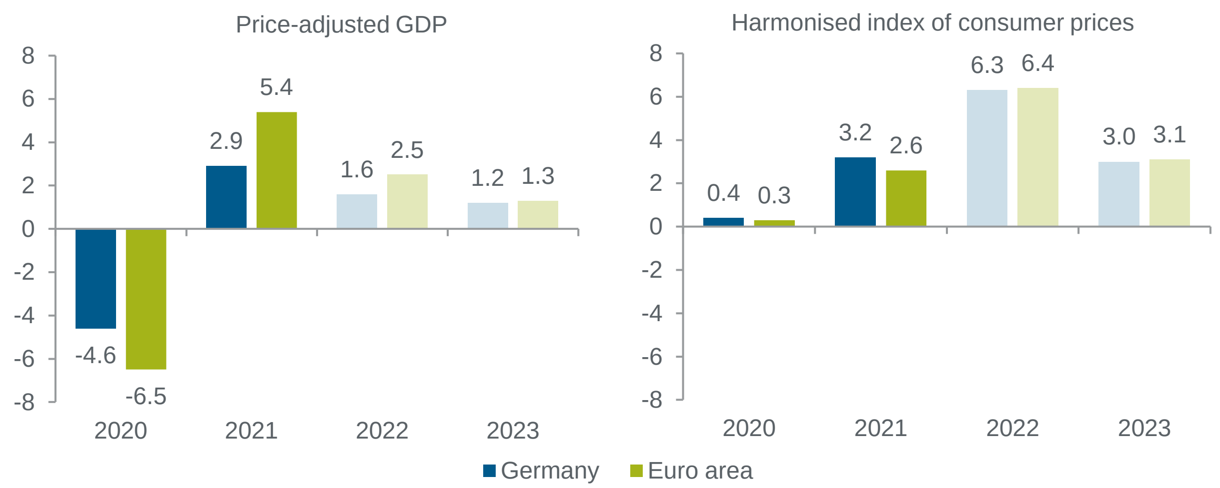
- While the dampening effects of the pandemic are waning and contact-intensive services are recovering, Russia’s war of aggression is prolonging global supply chain problems, sending energy costs soaring and weighing on household purchasing power.
- KfW Research expects real growth of 1.6% for 2022 and 1.2% for 2023 in Germany (pre-war forecast: +3.2% and +2.9%). The recovery of consumption in the summer half-year will turn out relatively weak and in the winter half the economy will nearly stagnate.
- Due to high energy prices and persistent supply bottlenecks, Germany’s inflation rate will be a very high 6.3% in 2022 before dropping to 3.0% in 2023. Prices in the euro area are expected to develop at a very similar pace (2022: +6.4%; 2023: +3.1%).
- Real growth in the euro area will be 2.5% in 2022 and 1.3% in 2023. The rate for 2022 reflects the higher momentum from the previous year as well as the lower share of manufacturing compared with Germany, which was hit particularly hard by supply bottlenecks.
- The level of uncertainty is exceptionally high. The new forecast is based on the assumption of persistently high energy prices but no natural gas embargo. If it comes to a gas embargo the consequences for the economy can be expected to turn out much worse.

Figure 1: Economic growth and inflation

Per cent year-over-year change



Source: KfW Research, Destatis, Eurostat

War has dashed hopes of a vigorous recovery

The start of the year 2022 gave good cause for hope of a strong economic recovery with the foreseeable end of all economically relevant pandemic restrictions and easing tensions in global supply chains. A revival of demand for contact-intensive services was already discernible in the course of the first quarter (hospitality turnover in March: +6.2% in real terms on the preceding month), while industrial output in February expanded for the fifth consecutive month. The war of aggression unleashed on 24 February abruptly dashed these hopes. In a single stroke, Russia's invasion of Ukraine drove up prices of commodities and energy, which were already on the rise as the pandemic was subsiding, fuelling the already high inflation rate. Measured against the EU-wide comparable Harmonised Index of Consumer Prices (HICP), inflation in Germany reached a new post-unification high of 7.8% in April, with the energy component alone surging by 35.3%. At the same time, Russia's aggression exacerbated material shortages. The automotive industry, for example, is missing cable harnesses from Ukraine. At the same time, China's strict zero-COVID policy prompted a strict and prolonged lockdown in the globally important economic hub of Shanghai, putting added strain on already disrupted global supply chains. In the short term, all of this put significant pressure on industrial output, which fell by 4.6% on the previous month. Even in this environment Germany's first quarter 2022 gross domestic product (GDP) – adjusted for price, seasonal and calendar variations – managed to grow by 0.2% on the previous quarter, after contracting slightly (-0.3%) in the final quarter of 2021 as a result of pandemic restrictions imposed to contain the Omicron wave.

Economy will remain under pressure for now

These developments will hamper economic growth in the coming quarters as well. Material shortages in manufacturing decreased only marginally in April. According to a survey by the Ifo Institute, three quarters of enterprises were still struggling with supply bottlenecks in raw materials and inputs (March: 80%). In the construction industry the material shortage actually worsened of late – for example in structural steel, of which Russia and Ukraine are important suppliers. As the active workforce rose above the pre-pandemic level for the first time again in March with a good 45.2 million people back in employment, the positive labour market development, the recovery of services industries after the end of pandemic restrictions and the recently launched economic relief packages for households and enterprises are still likely to enable quarterly growth rates of around ¼% in the current and coming quarter. But due to the high prices of energy and foodstuffs in particular, a post-pandemic consumption boom will no longer take place irrespective of the elevated savings buffers which households built up during previous lockdowns. GfK's Consumer Confidence Index, for example, underscores this in quite drastic terms. In April it fell to a new historic low, with savings propensity rising sharply and real income expectations falling considerably because of the high inflation. On the production side, the frequent shutdowns in China which are likely to continue on a recurring basis and trade disruptions caused by the Ukraine war will constitute major stress factors for the foreseeable future. To be sure, Germany is moving faster to reduce its dependence on Russian energy, among other things by diversifying suppliers, rushing to install mobile liquefied natural gas terminals and accelerating the expansion of renewable energy. In the short term, however, high energy prices will keep production costs high particularly at the beginning of the supply chain (for metals and chemicals, for example) and will therefore also be felt in downstream stages. The uncertainty about the progression of the war and the related structural changes in the global economy are dampening investment appetite around the world, which will negatively affect exports as well as business investment – given that Germany primarily exports capital goods. The high level of uncertainty among businesses is illustrated by the KfW-ifo business expectations for SMEs and large enterprises, for example, which collapsed in March and have recovered only insignificantly since then. It is therefore likely that the German economy will do little more than stagnate in the coming winter half of 2022/2023. By that time the moderate push provided by the recovery of services consumption will subside, particularly since the temporary reduction in fuel taxes and the 'nine-euro ticket' for suburban and regional public transport will end in autumn.

Rebound only in the course of 2023

Economic growth is only expected to pick up again when the inhibiting factors subside and supply chain problems ease across the board. We currently expect this to occur from the spring of 2023. That is when manufacturers will be reducing the record-high order backlog, stimulating growth in the further course of the year. However, that is not very likely to generate very strong quarterly growth rates either because by that time aggregate economic demand will have to process tangible declines in real incomes and purchasing power losses.

GDP forecast for Germany: 1.6% in 2022 and 1.2% in 2023

Caught in the grip of the war, German GDP will grow by 1.6% overall in 2022, a much lower rate than the 2.9% in 2021. In our pre-war forecast of February we had predicted real growth of 3.2% for the current year. In 2023 average annual GDP growth will then drop to as low as 1.2% (pre-war forecast: +2.9%).[i] However, this clearly reflects the low starting level of GDP due to the quasi-stagnation which we expect during the coming winter half-year. By contrast, the economic recovery during the year 2023 will present itself much more favourably than what the low average annual rate implies. This is illustrated by the overall annual rate, that is, the GDP variation in the final quarter compared with the final quarter of the preceding year. We predict a 2.0% annual rate for the year 2023 overall but only 0.9% for 2022. The uncertainty is currently exceptionally high. Our forecast assumes persistently high energy prices but no natural gas embargo. Irrespective of what would trigger an embargo, it would presumably result in a significantly worse economic development than predicted here (see box: Natural gas embargo and other forecast risks).

Inflation is set to ease only gradually up to the end of 2023

Germany's monthly inflation rate will probably begin trending downward in the course of the second half of 2022 so long as

[i] On average for all federal states, the year 2022 has one less working day and 2023 has two fewer working days than the previous year. The contribution of the annual variation in the number of working days to average annual GDP growth is neutralised in the calendar-adjusted calculation. Adjusted for calendar effects, our forecasts translate into average annual GDP growth rates of 1.7% for 2022 and 1.4% for 2023.

energy prices at least stagnate. The planned oil embargo with its long transitional periods is also likely to make little difference to this. On average for the year 2022, the inflation rate as measured against the HICP will settle in at 6.3%, primarily as a result of the sharp year-on-year increases in energy prices and noticeably higher costs of inputs amid a simultaneous recovery of consumption demand. The ongoing pass-through of higher production costs to consumer prices and an increase in wages, among other things due to the sharp rise in the minimum wage in October 2022, are set to keep inflation at 3.0% in 2023 as well, which is still well above the monetary policy target of 2% on average. Our forecast for the overall HICP inflation in the euro area is very similar (2022: +6.4%; 2023: +3.1%).

GDP forecast for euro area: 2.5% in 2022 and 1.3% in 2023

The same major forces are at work in the overall euro area economy as in Germany: the war in Ukraine, material bottlenecks, energy price increases and the coronavirus pandemic. Differences in the growth profiles of the euro countries and between individual countries and the euro area as a whole are essentially the result of differences in timing of individual pandemic waves including related health policy interventions and their interplay with the countries' economic structure, in other words, the respective shares of manufacturing and contact-intensive services such as tourism, in particular, in aggregate economic value-added. After the outbreak of the pandemic and the strict lockdowns imposed, GDP in the other three large euro countries Italy, France and Spain had dropped much more steeply in 2020 than in Germany, where the high share of industrial activity initially acted as a stabiliser (see table).

Table: Price-adjusted GDP growth in the euro area

Per cent year-over-year change

	DE	FR	IT	ES	EA
2020	-4.6	-8.0	-9.1	-10.8	-6.5
2021	2.9	7.0	6.6	5.1	5.4
2022	1.6	2.7	2.6	4.8	2.5
2023	1.2	1.1	1.1	2.6	1.3

Source: Destatis, Eurostat, KfW Research

Accordingly, the pace of the recovery there in 2021 was higher after the removal of the pandemic restrictions, so that the euro area was able to start off the year 2022 with significantly more momentum than Germany. The statistical overhang from 2021 is significantly higher there than in Germany (+1.9% vs. +1.1%). Moreover, Germany has been hit particularly hard by current developments because of the importance of its manufacturing sector and the significant role of its automotive industry. On balance, noticeably higher real growth can therefore be expected for the euro area again for this year, as was already the case in 2021. We expect price-adjusted growth of 2.5% for 2022, followed by 1.3% in 2023 (pre-war forecast: +3.6% and +2.7%). Among the major euro countries, Spain has the largest catch-up potential and should achieve the highest real growth rates in both 2022 and 2023 provided tourism continues to recover. In the first quarter of 2022, Spain's GDP was still 3.3% below its pre-crisis level of the final quarter of 2019, much lower than Germany's (-0.9%). The euro area as a whole, on the other hand, returned to pre-crisis levels already in the final quarter of 2021, with France's clear and fast recovery in particular making a positive difference. In the first quarter of 2022 French GDP was already 1% above its pre-crisis level.

Box: Natural gas embargo and other forecast risks

Like all forecasts, ours is also subject to a number of uncertainties that can lead to higher or lower growth rates than predicted. But since the further development of the Ukraine war and the sanctions yet to be imposed are nearly impossible to anticipate, forecast uncertainty is currently much higher than normal. Besides, the coronavirus pandemic continues to simmer and might impact the German and euro area economies directly, for example if a new variant makes economically relevant restrictions necessary again, or indirectly, as currently illustrated by the strict lockdown in Shanghai. Besides the obvious worsening of supply chain problems, recurring or broad lockdowns in China might also trigger a global slump in demand. The latter may also occur if central banks go too far in the fight against inflation or if the very high current inflation rates can only be lowered by a monetary policy-induced recession. Another scenario that is particularly acute is that of a Russian natural gas supply stop or embargo. Besides an additional rise in inflation due to even higher energy prices, a certain need for rationing would then also have to be expected, which would primarily affect manufacturing under the current legal situation. Several studies on the potential consequences have now been released which estimate short-term losses in value-added between 1% and 8% of GDP. That would be compounded by demand-side effects such as the additional loss in purchasing power, which the Deutsche Bundesbank has estimated at approx. 2 to 4% of GDP. An integrated modelling of demand and supply-side effects was prepared as part of the joint economic forecast of the economic research institutes DIW, IfW, ifo and RWI: According to these, a complete energy embargo from spring of 2022 would result in a reduction in growth of 0.8 percentage points for 2022 and 5.3 percentage points for 2023. The findings, which already diverge heavily with regard to the supply-side effects alone, depend primarily on the respective assumptions on the availability of natural gas after the stop of Russian gas supplies and the savings potentials, for example in electricity generation and households – before rationing in the industrial sector. What is also crucial are the extent to which natural gas can be substituted in the production process and losses in downstream stages of the value chain (cascade effects). In 2021 natural gas still accounted for 27% of Germany's primary energy consumption, making it the second most important energy source after mineral oil (32%). At the same time, Russia supplied around half of Germany's natural gas needs in 2021. Thanks to increased liquefied natural gas imports, however, the share of Russian gas has now dropped to 35% and the federal government is aiming to reduce the share to around 30% by the end of the year. As the flow of gas from Russia has remained largely stable thus far, gas storage facilities can now be filled relatively quickly. Therefore, the effects of a (permanent) supply stop will generally reduce over time and depend on developments such as the timely availability of the planned mobile liquified natural gas terminals. Furthermore, optimisation potentials might arise from market-based allocation procedures for natural gas, while the modelling that we are aware of assumes blanket reductions in gas consumption. However, positive surprises that may generate more growth than predicted here are also possible, particularly in the coming year. The substitution of Russian energy and commodities may run more smoothly than currently expected, for example because new supply sources are quickly developed or if the transition to renewables speeds up substantially. An improvement in the energy supply situation is likely to reduce pressure on prices and costs at least in the medium term and thereby strengthen purchasing power. A peaceful solution for Ukraine that is accepted by all sides would eliminate the uncertainties created by the war in one fell swoop, give businesses much more confidence in the future and initiate reconstruction and could thus provide new economic impetus through investment, especially in Europe.