KfW Research
KfW Business Cycle Compass

Between stagflation and recession

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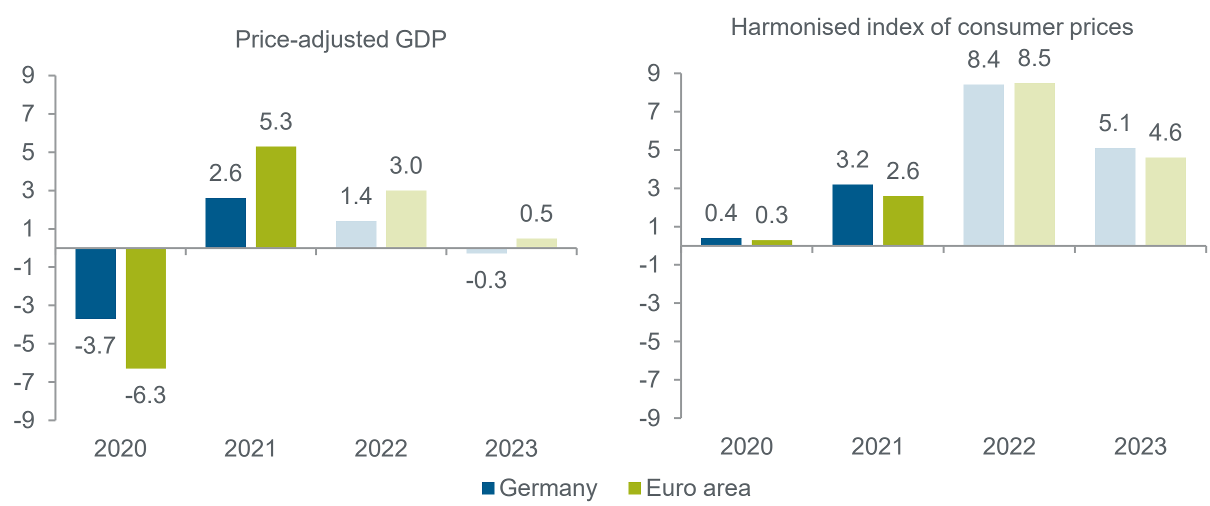
– The economic outlook has deteriorated further. Headwinds are now likely to predominate. Both Germany and the euro area are likely to see negative quarterly growth rates by the winter half-year at the latest.
– KfW Research expects real growth of 1.4% in Germany for 2022. In 2023 Germany's economic output is set to contract marginally by -0.3% (previous forecast: +1.6% and +1.2%), which in material terms is a stagnation and not a genuine recession.
– In the event of a complete stop of gas supplies and subsequent rationing in the manufacturing sector, we expect Germany's GDP to contract by around 2.5% in 2023.
– The German inflation rate will be very high with 8.4% on average across the year 2022, mainly due to sharp rises in energy and food prices after the outbreak of the war in Ukraine. Inflationary pressure will gradually weaken from 2023, although the annual inflation rate will only drop to 5.1% because of high rates at the start of the year. Prices in the euro area are expected to develop at a very similar pace (2022: +8.5%; 2023: +4.6%).
– Real growth in the euro area is predicted to reach 3.0% in 2022 and a mere 0.5% in 2023. This reflects the higher momentum from the previous year compared with Germany. But the euro area is also benefiting more from the catching-up movement in the service industries.

Figure 1: Economic growth and inflation

Per cent year-over-year change



Source: KfW Research, Destatis, Eurostat

Minimal growth in the second quarter

In the second quarter the upward and downward forces acting upon the German economy were still roughly equal, so that a minimal rise of 0.1% in price-adjusted gross domestic product (GDP) was reported. To be sure, the inflation-induced losses of purchasing power and the shift in consumption to services led to a veritable collapse of 4% in real retail turnover from the previous quarter. However, the pent-up demand for services that were previously under pandemic restrictions prevailed so that private consumption nonetheless expanded by 0.8%. Hospitality, in particular, boomed in the spring and experienced a price-adjusted 24% surge in turnover from the previous quarter, which had still been partly affected by pandemic restrictions. Overall services output in April and May was almost 6% above the level of the first quarter, and most recently 8% above the pre-crisis level of February 2020. After Russia's invasion of Ukraine and the strict lockdowns in China, however, new material shortages hit manufacturing and, in particular, construction, significantly limiting output. Massive energy price increases also weighed on production in energy-intensive manufacturing sectors. On the expenditure side, supply problems were mainly reflected in significant declines in construction investment and, hence, weak investment activity overall. Real exports grew, but the trade balance was negative overall as a result of even stronger import growth.

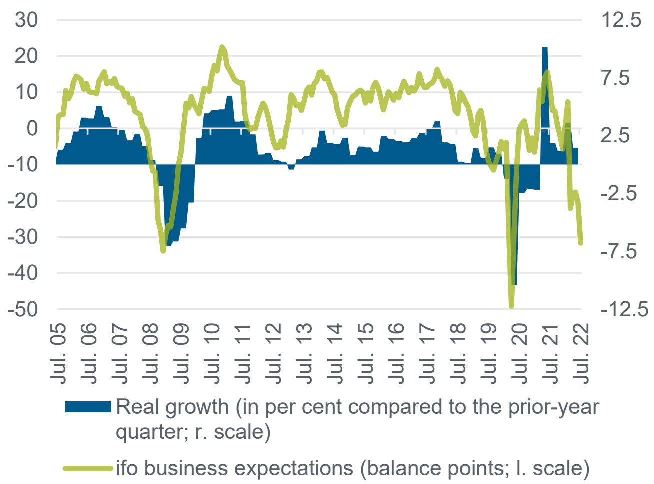
Economic outlook is now much gloomier

After the catching-up movement in the service sector has been largely completed, the downward forces on the economy are now likely to predominate, primarily emanating from the fallout of the war in Ukraine and the energy crisis it created. While Russia has not yet stopped to provide gas compleely, the already very high wholesale price of gas has nearly tripled once more since May as a result of strongly reduced and highly uncertain supplies from Russia. However, a gas shortage leading to significant rationing is rather unlikely provided Russia maintains current supply quantities.[1] Nonetheless, further increases in gas and electricity costs will put significant pressure on private consumption and production in energy-intensive manufacturing sectors. Furthermore, low water levels on the Rhine river are also likely to affect industrial output to a certain degree in the current and next quarter.[2]

The global economic environment has also weakened. Unusually high inflation rates are depleting the purchasing power of households around the world, and almost all large central banks have now shifted to monetary tightening that will slow consumption and investment demand. Given the early onset of particularly persistent inflationary pressure in the US, monetary tightening there is already well advanced, as the country's economy slowed down significantly in the first half of the year and economic forecasts for this and the coming year have been downgraded very sharply. China, the world's second-largest economy, is grappling not with inflation but mostly with recurring lockdowns resulting from a zero-COVID policy, leading to a sharp drop in economic output in the second quarter. And the current real estate crisis is still likely to reduce growth before the end of the forecast period.

Given the multitude of problems, sentiment indicators have deteriorated sharply since March. The household consumer confidence level measured by the European Commission is now on the lowest level since 2002.[3] The German Consumer Confidence Index surveyed by GfK has even fallen to the lowest level since post-unification surveys began in 1991.[4] The forward-looking components of business surveys are also very pessimistic. Thus, Ifo business expectations have now dropped to a level previously seen only ahead of major recessions (Figure 2), and the business outlook surveyed for the Purchasing Managers' Index is now negative across all sectors as well. Assessments of the current business situation, by contrast, still managed to stay relatively steady in the second quarter. But they, too, declined markedly since the start of the summer quarter. According to the Purchasing Managers' Index, for example, Germany's economic activity has been within the contraction zone since July, and the economic situation in industrialised countries has also dimmed significantly at the global level.

Figure 2: Business expectations are down to recession level



Source: Destatis, ifo Institute

Despite all difficulties, however, upward forces continue to exist which will yet stabilise economic output in coming quarters. Thus, although orders received in the manufacturing sector have been on a downward trend already since mid-2021, the boom in demand up until then and the materials shortages that hampered production have led to the buildup of a record-high stock of orders that will potentially make up for any lack of new orders. With the rapidly declining global demand for goods and investment in new capacity already undertaken, global supply shortages are now also easing so that at least part of the stock of orders can go into production in the coming quarters.[5] At the same time, household consumption will likely stabilise on the back of estimated excess savings of EUR 185 billion accumulated in the years 2020 and 2021 – even if these savings are likely distributed too unevenly to fully make up for the inflation-induced purchasing power losses. Energy transition investments in businesses and residential construction are also likely to bolster investment, although the stress factors for private investment activity resulting from rising interest rates, pessimistic business expectations and high uncertainty will likely predominate. The recently decided special fund for the German Armed Forces will boost public investments in the forecast period.

On balance, we expect slightly negative quarterly growth rates in the current third quarter and particularly for the winter half-year 2022/2023. A return to a moderate growth path is unlikely until the spring of 2023, when uncertainty over gas supplies decreases, energy-intensive industries have adapted their production and rising nominal wages combined with falling inflation rates slightly improve the trend in real incomes of most consumers again.

Technical recession in Germany

A continuing large statistical overhang from the previous year is making the growth rate in the current year look better than it is, and a significant upward revision of the first-quarter growth from +0.2 to +0.8% made by the Federal Statistical Office is having a positive effect. We have therefore downgraded our forecast of price-adjusted growth in 2022 by only 0.2 percentage points to +1.4% despite a considerably worse outlook on the second half of the year.[6] The predicted contraction in economic output in the second half and at the start of 2023 will mainly affect the growth forecast for the coming year, which we have downgraded from +1.2 to -0.3%. At least two consecutive quarters of negative growth means that the definition of technical recession is fulfilled. In practical terms, however, our economic forecast points to stagnation in the coming year, not genuine recession. The predicted slight contraction of GDP includes 0.2 percentage points attributable to a lower number of working days in 2023, in other words, a negative calendar effect.

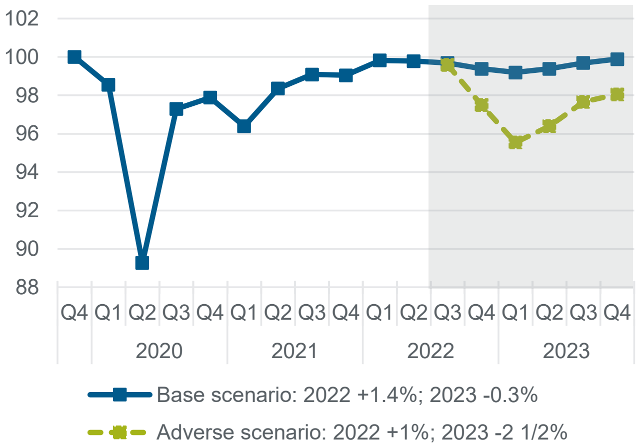
Adverse scenario: a stop of gas supplies and rationing

The economy is likely to perform more poorly, however, should Russia cut its natural gas supplies entirely any time soon. First, even steeper losses of purchasing power and decreases in consumption would have to be expected as a result of even higher expenditure on energy. Second, gas rationing would become more likely, mainly affecting large industrial enterprises. Not only would companies subject to rationing suffer direct production losses; such losses could also trigger significant second-round effects through supply chain links. Whether and to what extent gas would have to be rationed is still highly uncertain as it depends on many unknown variables such as temperatures this coming winter and savings in electricity generation and protected places of consumption such as households.[7] This uncertainty is also apparent in the forecasts of various institutes. While simulations performed by the economic research institutes involved in the joint economic forecast illustrate that it is now more likely that replacement supplies and savings by households and businesses can prevent rationing of industrial gas consumption, the Deutsche Bundesbank as recently as in June still expected significant rationing and production losses in the event of a halt to gas supplies.[8]

We assume as a middle path that in addition to production-neutral savings in all consumption segments, the fourth quarter of 2022 and the first quarter of 2023 will see further rationing of 10% to 20% of gas consumption in particularly gas-intensive industrial sectors, leading to just under 3% less gross value added per quarter as a result of direct production adjustments and second-round effects. Along with the additional purchasing power losses resulting from even higher energy expenditure, Germany's GDP is then likely to contract by around 4% from the second quarter of 2022 up to the first quarter of 2023. A recovery could then be expected to set in, although economic output is likely to also be well below the current level even at the end of 2023 as natural gas supplies will presumably remain costly and uncertain (cf. Figure 3). In the adverse scenario, we still predict real growth of just under 1% on average for the year 2022 and a contraction of approximately 2.5% for 2023.

Figure 3: Forecasts for German GDP

Adjusted for price, seasonal and calendar variations; index: Q4 2019 100



Source: Destatis, KfW Research

GDP forecast for the euro area: 3.0% in 2022 and 0.5% in 2023

The euro area is generally subject to the same economic forces as Germany. In particular, the inflation-induced purchasing power losses have translated into very negative consumer sentiment everywhere, and retail turnover has been on the decline in the euro area already since the start of the year. Nonetheless, many euro area member states, especially the large countries France, Italy and Spain, benefited to a particular degree from the strong recovery in the tourism sector in the past quarter. Another advantage they currently enjoy is that manufacturing plays a lesser role for their economy and is also slightly less dependent on international value chains and Russian natural gas supplies.

Euro area growth therefore proved to be surprisingly strong in the first half of the year. It was 0.5% in the first quarter and even reached 0.7% in the second. Euro area GDP has thus already surpassed the pre-crisis level of Q4 2019 by 1.5%, while Germany barely matched it in the second quarter. In the current quarter the impetus from the recovery of tourism will likely subside in the euro area as well, however, before headwinds start to dominate in the autumn and the euro area also drifts into a technical recession. Because of the surprisingly strong first half, we are nonetheless raising our forecast for 2022 to 3.0%, while we predict price-adjusted GDP growth of just 0.5% for 2023.

Table: Price-adjusted GDP growth in the euro area

Per cent year-over-year change

	DE	FR	IT	ES	EA
2020	-3.7	-7.9	-9.1	-10.8	-6.3
2021	2.6	6.8	6.6	5.1	5.3
2022	1.4	2.6	3.3	4.6	3.0
2023	-0.3	0.4	0.3	1.4	0.5

Source: Destatis, Eurostat, KfW Research

Gas prices will lead to a new surge in prices in autumn

Energy price inflation in Germany is likely to spike again in the autumn, driven by the recently adopted gas levy and regular gas and electricity retail price adjustments to reflect the massive increases in wholesale prices. Besides, disinflationary measures such as the 9-euro ticket and the fuel tax rebate are about to expire. This is further delaying the downward trend in the inflation rate. On average across 2022, inflation in Germany is predicted to sit at 8.4% as measured by the EU-wide comparable Harmonised Index of Consumer Prices (HICP). In addition to energy prices, food prices in particular are adding to high inflation. However, the reported monthly inflation rate is likely to drop in the course of the year 2023 as base effects from the previous year will reduce the contributions from energy and food price inflation. Increases in wages and prices of services from the end of 2022, however, will keep inflationary pressure high on prices excluding energy and food (core rate). In the second half of 2023 the core rate will likely exceed the total inflation rate over several months. In the medium term, however, economic weakness and the ECB's tighter monetary policy will also dampen core inflation. For 2023 as a whole, we expect the inflation rate to remain at a very high 5.1%, but mainly because rates will be high at the start of the year. Our forecast for the HICP in the euro area is for very similar inflation rates overall (2022: +8.5%; 2023: +4.6%). In the event of a complete stop of Russian gas supplies, inflation would be even higher than in the base scenario, especially in 2023, but the inflation-reducing effect of recession could subsequently predominate.

Numerous risks even beyond the energy crisis

Forecast risks arise from the uncertain extent of the gas supply gap in the coming winter, among other factors. Should protected consumers fail to achieve sufficient savings and if replacement imports and substitution options are missing, for example if electricity generation from coal is hampered by the low water level in the Rhine river, there is a possibility that significant gas rationing will become necessary even if 20% of Nord Stream 1's capacity continues to be supplied.[9] The consequences of such rationing, in turn, are unpredictable as value chains and second-round effects can only partly be modelled. Conversely, if savings and substitution measures are successful it may even be possible to prevent a gas shortage without incurring significant rationing losses even if gas supplies are stopped completely. The familiar unknown variables with potentially significant economic effects on Germany and the euro area, however, also include developments beyond the current energy crisis. Recurring lockdowns in China could spark new material shortages or even exacerbate the global economic weakness. A slump in demand can also occur if central banks oversteer in their fight against inflation or if inflation becomes so entrenched that it can only be defeated through a monetary policy-induced recession. Geopolitical risks have been omnipresent in any case since Russia's invasion of Ukraine but have taken on a new dimension again with China's threatening gestures against Taiwan, particularly as the People's Republic is Germany's most important trading partner.

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[1] The institutes contributing to the joint economic forecast estimate rationing only in a worst-case scenario. The Federal Network Agency does not assign its scenarios any probabilities of occurrence but demonstrates that a severe gas shortage is avoidable. Cf. https://gemeinschaftsdiagnose.de/wp-content/uploads/2022/07/Gemeinschaftsdiagnose_Sonderauswertung-Gasluecke_Juli-2022.pdf.

[2] According to a study by the Kiel Institute for the World Economy (IfW), in a month with 30 days of low water, industrial production in Germany declines by about 1%, which corresponds to a reduction in GDP of approximately 0.2%. Water levels usually rise again significantly by the end of the year. Cf. https://www.ifw-kiel.de/fileadmin/Dateiverwaltung/IfW-Publications/Saskia_Moesle/KWP_2155_low_water_econ_activity.pdf.

[3] At the time, rapidly growing unemployment in particular weighed on consumer confidence.

[4] https://www.gfk.com/de/presse/konsumklima-von-inflation-stark-gebeutelt.

[5] See e.g. the Global Supply Chain Pressure Index of the New York Fed: https://www.newyorkfed.org/research/policy/gscpi#/interactive.

[6] The price-adjusted GDP growth rate forecast here is primarily communicated in Germany but contains distorting effects resulting from the annual fluctuations in the number of working days. This year the calendar effect accounts for just under -0.1 and next year -0.2 percentage points. Consequently, the forecast GDP growth rate is 1.5% (2022) and -0.1% (2023) on a price- and calendar-adjusted basis.

[7] For more on ways to reduce natural gas consumption see e.g.: https://www.econtribute.de/RePEc/ajk/ajkpbs/ECONtribute_PB_034_2022.pdf.

[8] Cf. https://gemeinschaftsdiagnose.de/2022/06/28/gefahr-einer-gasluecke-gegenueber-april-deutlich-verringert-aber-versorgungsrisiken-bleiben/ und https://www.bundesbank.de/resource/blob/892740/2e8cf5a20b3663680dea9e146dee5a71/mL/2022-06-monatsbericht-data.pdf.

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