Headwinds abound, but a consumption-driven recovery is on the cards

25 August 2023

Authors: Dr Philipp Scheuermeyer, +49 (0)69 7431-4017, philipp.scheuermeyer@kfw.de
Dr Klaus Borger, +49 (0)69 7431-2455, klaus.borger@kfw.de
Stephanie Schoenwald, +49 (0)69 7431-6446, stephanie.schoenwald@kfw.de
Press contact: Christine Volk, +49 (0)69 7431-3867, christine.volk@kfw.de

– After a very slight contraction in the first half of the year, the economic situation remains sluggish in the summer. However, significant wage increases along with easing inflationary pressure should revive the economy towards the end of the year.

– KfW Research expects the economy to shrink by a moderate -0.4% in 2023. GDP is set to grow by 0.8% in 2024. Previous forecasts were for- 0.3% for 2023 and +1.0% for 2024.

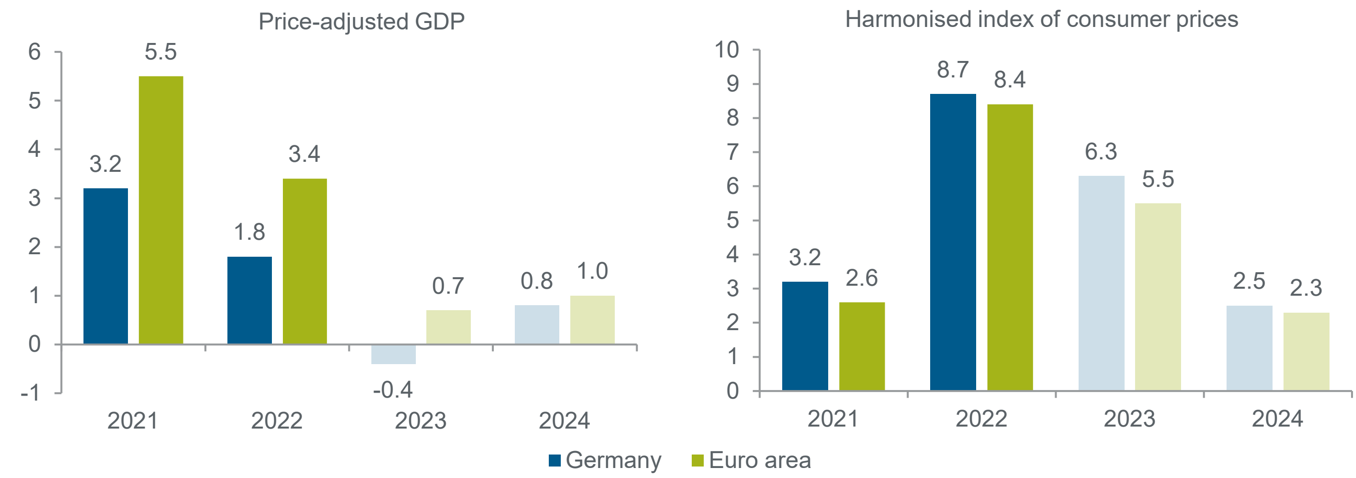
– After 6.3% in 2023, KfW Research expects inflation to drop to only 2.5% in 2024 (HICP). The contribution of energy to inflation is falling rapidly, and price pressure on goods is clearly easing. But because of strong wage growth, services and core inflation will take a bit longer to fall back.

– Ecological price tag for GDP: The predicted economic trajectory means that Germany’s greenhouse gas emissions are expected to drop, but the decline will fall short of the reduction target for 2030 by 5% in 2023 and by nearly 6% in 2024.

– The euro area is carrying greater momentum over from the previous year and also expanded in the first half of 2023. Its GDP will likely grow by 0.7% in 2023 and by 1.0% in 2024. We expect inflation to hit 5.5% and 2.3%.

Figure 1: Economic growth and inflation

Per cent year-over-year change



Sources: KfW Research, Destatis, Eurostat

The economy virtually stagnated in the first half

Despite the enormous supply shock caused by the war in Ukraine and the shutdown of gas supplies from Russia, Germany's economic output still grew by 1.8% across all of 2022 and contracted only minimally in the first half of this year, according to current data. After gross domestic product adjusted for price, seasonal and calendar variations fell by 0.1% in the first quarter, according to the most recent calculations by the Federal Statistical Office, it stagnated in the course of the second quarter. Consumption has stabilised after household consumption expenditure previously fell significantly and public consumption expenditure literally plunged at the start of the year as the pandemic support measures ended. This benefited the services sector in particular, where the price and seasonally adjusted production index was around 3% higher on average in the second quarter than in the preceding quarter. Retail turnover, which was already in a clear downward trend since early 2022, also recovered by a moderate 1.1% in the spring quarter. But developments in manufacturing were disappointing, as industrial production contracted by 1.3% in the second quarter after a fairly strong increase in the first quarter, even though supply bottlenecks continued to ease and energy prices decreased significantly. In the construction sector, production decreased as expected, after recovering briefly in the previous quarter thanks mainly to exceptionally mild weather.

Leading indicators have deteriorated markedly…

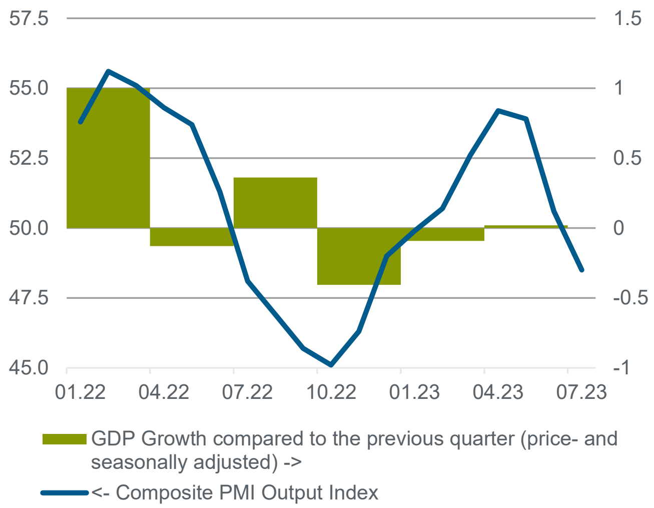
More disappointing than the development of gross domestic product in the second quarter is the most recent trend in sentiment indicators obtained by business surveys. At face value, they point to a recession or at best to ongoing stagnation in the second half of the year. In May, the Ifo business sentiment index changed direction after an extended catching-up movement. A similar trend can be seen in the composite output PMI, which still suggested growth in the second quarter but has again signalled a contraction of private sector economic activity in Germany since July. According to the sentiment indicators, the mood in construction and civil engineering as well as manufacturing is particularly dismal, and the growth momentum and business situation of enterprises from the services sector have now declined notably as well.

… while conditions have remained largely unchanged

Meanwhile, economic conditions in Germany have hardly changed. The dissolution of the two major supply shocks continues to have a stabilising effect. The material shortages that were so omnipresent in manufacturing and construction last year are easing further, and the import prices for fossil fuels are in a steep downward trend. Both developments are leading to falling producer prices and decreasing consumer price inflation (see next section). In combination with accelerated wage growth, this suggests that household purchasing power will increase again soon and the growth in consumption that was revived in the past quarter will continue. In order to reduce inflation, however, monetary policy is still putting the brakes on economic activity, which explains much of the downturn in construction and some of the problems of the manufacturing sector. While the ECB and the Fed have probably reached or almost reached the peak of their interest rate cycles, interest rate reductions are unlikely to begin until sometime in the course of 2024. The planned fiscal consolidation to comply with the debt brake is also likely to provide a negative fiscal impulse in the coming year.

Figure 2: Economic momentum in Germany

PMI>50 signals growth in private sector economic activity; <50 signals contraction.



Source: Destatis, S&P Global, Macrobond

Inflation is still trending down

The easing of supply bottlenecks is visibly filtering through to consumer price inflation, which dropped from 11.6% in October 2022 to 6.5% in July 2023, according to the Harmonised Index of Consumer Prices (HICP). In particular, the contribution of energy prices to inflation, which was still very large last year, has decreased substantially since the end of 2022 and is expected to turn negative in the course of the year. Annual food inflation is still very high, yet it is likely to have passed its peak in March and given the significant decline in agricultural producer prices on the previous year, consumer prices can be expected to continue falling in this area as well. However, pressure on core inflation, that is, without the volatile prices for energy and food, still persists: the rate of change compared to the previous year, which is in the centre of public attention, has risen to 6.2% by July and month-on-month rates of change, which are not distorted by base effects from the previous year, have been fluctuating around a high level for months. As wage growth has clearly picked up, and demand in this area has been relatively steady, prices for the particularly important services component in the basket of goods have recently risen fast. But inflation in the goods component has already fallen noticeably since the beginning of the year, and the decline in producer and wholesale prices which has been underway in recent months in combination with sharply falling sales price expectations suggests that the downward trend will continue. After strong growth in profit margins across the economy in the years 2021 and 2022, the high wage growth in the forecast period is also likely to be offset in part by falling profit margins. We therefore also expect services inflation to decrease slowly in the coming quarters and generally predict that the downward trend in reported monthly total inflation rates will continue. Inflation in Germany is set to remain on a very high 6.3% on average this year (HICP) before dropping to just 2.5% in 2024. Core inflation in 2024 is likely to sit at around 3%, slightly higher than headline inflation. In addition to effects from the always volatile energy and food prices, inflation risks mainly include uncertainties about the rate of future wage growth and its effect on inflation.

Wage growth is stabilising household consumption

Even if strong wage growth poses a risk to achieving the ECB's inflation target, it is likely to act foremost as a driver of economic activity in the coming quarters by reviving household consumption. According to Bundesbank data, the growth of actual earnings per employee was a strong 5.7% in the first quarter of 2023, and a similar rate of wage growth can be expected in the coming quarters given the level of the collective wage agreements recently negotiated and the fact that skilled labour shortages remain very pronounced even despite weak economic performance. If employment remains at least steady during the forecast period and inflation continues to ease, this will result in a considerable increase in aggregate wages which will provide households with additional purchasing power again in the coming quarters. Consumption will likely experience additional impetus from the slight drop in the saving rate, which has thus far fallen only to the pre-crisis level in Germany despite a significant accumulation of savings during the pandemic. As an indicator of growing consumption, household consumer confidence has already recovered since the beginning of the year, although it remains on a below-average level.

Monetary policy continues to slow construction investment

Further decreases in construction investment are likely, particularly in dwellings, since that is where the sharply higher financing costs resulting from the ECB's interest turnaround are felt particularly acutely. This will be compounded by persistently high construction costs despite significantly easing supply bottlenecks and very high prices of land. Incoming orders in the construction and civil engineering sector as well as building approvals are both pointing steeply downward. While the average volume of orders for the last three available months was 12% below the previous year's level, building approvals overall have even plunged by 35%. The only factors that stabilise construction investment are the volume of orders that has accumulated in the years up to 2022 and energy efficiency measures. A turnaround in construction is only likely to occur after the end of the forecast period, as financing costs are expected to decline by 2025 and land prices are likely to have softened somewhat.

Business investment is growing at a slow rate

Monetary policy is also putting the brakes on business investment. According to the Bank Lending Survey of the Deutsche Bundesbank, the current interest rate level is the main driver of the steep drop in demand for business loans since the end of 2022. According to the business surveys of the Ifo Institute and the Cologne Institute of Economic Research, however, in the spring of 2023 the majority of German businesses expected to invest more this year. The now heavily subdued expectations held by enterprises are likely to hamper investment activity. But given the urgent need for investment, particularly in energy transition, climate neutrality and digitalisation projects, and the pent-up demand for capital goods whose manufacturers were previously paralysed by supply problems, business investment is nevertheless likely to grow moderately in the second half and in the year 2023 as a whole. In the coming year, investment activity is then likely to accelerate slightly on the back of a consumption-driven economic recovery. Government investment is likely to expand noticeably, for the most part because of increased defence expenditure.

Exports remain weak for the time being but look set to rebound in 2024

After improving at the start of the year, the export expectations reported by German industrial firms under the Ifo Institute's business surveys have now fallen sharply again. China's economic performance in particular is disappointing, as the initial growth spurt resulting from the end of the zero COVID policy quickly dissipated while stress factors persist, such as the problems in the real estate sector. The US economy, in turn, proved to be surprisingly resilient to the Fed's monetary policy tightening, and the likelihood of a soft landing has risen. Nonetheless, the manufacturing indicators are rather weak there, too, and the pace of GDP growth is expected to at least slow down significantly in the second half of the year. We expect relatively sluggish growth of 3.0% and 2.9% for the overall global economy for 2023 and 2024. Gains in household purchasing power resulting from above-average wage growth along with a significant decrease in price pressure, however, are likely to lead to a renewed increase in growth momentum among important trading partners in the course of 2024. After the end of the forecast period, a global easing of monetary policy beginning in 2024 is likely to also act as a driver of demand for capital goods. But because the predicted recovery of consumption in Germany will also increase demand for imports, the external trade balance in 2024 is likely to be roughly neutral while arithmetically increasing growth in 2023 as a result of what will probably be a slight drop in imports across the year as a whole.

Output side: order books are stabilising production

In the services sector, the upturn that began already in 2021 is likely to weaken but continue at a diminished pace. As retail turnovers are already well below the pre-crisis trend and the post-pandemic shift in consumption from goods back to services is well underway, retail trade will also return to moderate growth again. At the same time, the outlook for the construction sector is significantly more negative, with value added set to contract at a similar rate as construction investment. Manufacturers have a similarly negative outlook if we look at incoming orders and sentiment indicators alone. To be sure, the volume of orders received in the second quarter developed positively overall thanks to significant increases in May and June, but with the exception of large orders, which are volatile and slow to impact on production, the downward trend that has been ongoing already since the beginning of 2022 has continued. The manufacturing PMI, which is composed of various sub-indicators, and the ifo Business Expectations are also very negative. The ifo Production Expectations, which have a relatively good forecast quality, are now pointing downward again. Right now, the German industrial sector as an important manufacturer of capital goods is likely being slowed down particularly by the global monetary policy tightening measures and China's economic weakness, while energy-intensive industries continue to experience price competitiveness as a major challenge.[1] The stock of orders, however, remains unusually high. In the survey by the Federal Statistical Office as well as that of the Ifo Institute, businesses responded that their forward order book was still significantly stronger than on average in the years before the pandemic

(Destatis: +1.9 months; ifo: +1.5 months). If they reduce their stock of unfulfilled orders to only a normal level, they should still have a sufficient buffer to offset imminent further declines in new orders. As the remaining production constraints due to material shortages should dissipate in the coming quarters, we expect production to remain more or less stable. Driven by the predicted rebound in consumption in combination with the likely imminent completion of the consumption shift, demand for industrial goods will probably also pick up again slightly in the course of 2024.

Figure 3: Volume of manufacturing orders

Source: Destatis

German growth: -0.4% in 2023; +0.8% in 2024

On balance, we expect a cyclical turnaround in the coming quarters that will be driven primarily by a revival of household consumption. Leading indicators for the current quarter are negative, but the continuing high stock of orders should sufficiently stabilise production so that a stagnation is more likely than a marked contraction. Thus, gross domestic product will more or less stagnate in the course of the year. Owing to the contraction at the end of the previous year (statistical carryover) and the fact that the year 2023 has around two fewer working days than 2022 (calendar effect), annual price-adjusted gross domestic product should be 0.4% below that of the previous year (previous forecast: -0.3%). On the assumption that quarterly growth will then accelerate moderately from the middle of next year, we forecast real growth of 0.8% for 2024 (previous forecast: +1.0%).

Pressure to take action on climate change remains high

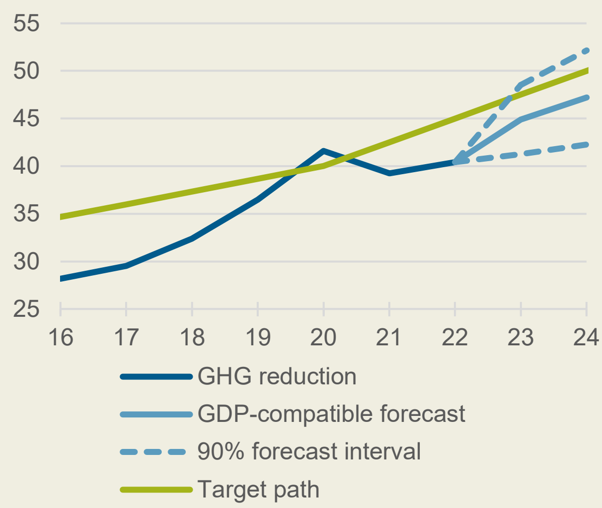
Pressure to act on climate change remains high. According to the ecological price tag for GDP, the new indicator we introduced with our autumn forecast for 2022, our current economic forecast implies that greenhouse gas emissions this year and next will be 5% and nearly 6% higher, respectively, than would correspond with the interpolated target trajectory of a 65% reduction by 2030 against the 1990 baseline (see box).

Box: Ecological price tag for GDP

Economic growth has a wide range of social and ecological consequences that are typically disregarded in the usual economic forecasts. It is a necessary but not sufficient condition for sustained prosperity, as the growing risks from climate change demonstrate in dramatic fashion. Global warming poses a threat to the natural foundations of human life and, therefore, to economic activity. It is therefore urgent to focus more comprehensively and rigorously than before on the impact of economic activity on the environment and climate in particular. To this end we have developed a simple approach for systematically integrating the expected greenhouse gas (GHG) emissions into our economic forecast for Germany.[2]

Figure 4: GHG emissions in Germany

Reduction against 1990 baseline in per cent



Source: Destatis, Eurostat, KfW Research

The starting point is an identity equation according to which total GHG emissions are the product of GDP and the emission of GHG per unit of GDP, in other words, GHG intensity. We take the GDP from our economic forecast and estimate the expected development of GHG intensity using a linear trend extrapolation. Our approach is explained in detail here. It enables the greenhouse gas emissions being expected under current conditions to be compared with the reduction targets set by policymakers, which require Germany to reduce its emissions by 65% against the 1990 baseline by 2030 (see Figure 4). That will sharpen our awareness of the trade-off that exists between more goods and income on the one hand and the consumption of key natural resources on the other hand. It means we attach an ecological price tag on GDP, as it were, that will tell us how much the expected growth will presumably cost us as a society in the form of GHG emissions that harm the climate.

On the basis of our new economic forecast, the ecological price tag predicts that emissions will drop this year and next, but at a lower rate than intended. Thus, Germany's GHG emissions are predicted to be around 33 million t CO_2 equivalent or 5% higher in 2023, and around 35 million t CO_2 equivalent or nearly 6% higher in 2024 than prescribed by the reduction trajectory set by policymakers (see Table 1).

The predicted additional average annual emissions are almost equal to Slovakia's total emissions in 2020 (37 million tonnes of CO2 equivalent).

Table 1: GHG emissions and policy trajectory
Million tonnes of CO_2 equivalents

	2020	2021	2022	2023
Actual/forecast	760	746	690	661
Target path	719	688	657	626
Actual/forecast deviation from target path				
Absolute	41	57	33	35
Percent	5.7	8.3	5.0	5.6

Source: Destatis, Eurostat, KfW Research

Like all forecasts, the ecological price tag for GDP also involves forecast risks. With reference to the 90% forecast interval presented in Figure 4, which is derived from the historic forecast errors of our approach, the statement that the reduction targets were missed in the forecast period appears to be empirically well validated.

Euro area expected to grow by 0.7% in 2023 and 1.0% 2024

For the summer quarter, the leading indicators such as the Composite PMI and the Economic Sentiment Index signal an economic dip of roughly the same magnitude across the overall euro area as in Germany. Among the big four, however, Spain is looking relatively good, which is due to both a booming tourism sector and the robust development of Spanish industry. Italy, meanwhile, is enjoying a favourable economic situation thanks to high allocations from the EU Recovery Fund, but is only able to exploit its potential to an incomplete extent and, due to the expiry of high subsidies for energy-efficient building renovation, is likely to show somewhat lower growth rates in the future than during the construction boom of the last two years. In France, which has successfully overcome the supply shocks of the past year, especially owing to a high share of services in gross domestic product and strong government intervention to reduce energy prices, the activity indicators based on business surveys have fallen particularly steeply in the past months. It will likely experience a mild contraction first before resuming moderate consumption-driven growth.

We expect the euro area economy as a whole to more or less stagnate in the current quarter before it returns to a slow pace of growth which will then accelerate towards the end of the forecast period. For 2023 as a whole, the better performance in the first half and the statistical carryover from the previous year set the stage for a significantly higher GDP growth rate of 0.7% for the euro area than for Germany. In 2024, the euro area growth rate is then likely to sit at 1.0%. We expect average annual euro area inflation rates of 5.5% in 2023 and 2.3% in 2024.

Table 2: Price-adjusted GDP growth in the euro area
Per cent year-over-year change

	DE	FR	IT	ES	EA
2021	3.2	6.4	7.0	5.5	5.5
2022	1.8	2.5	3.8	5.5	3.4
2023	-0.4	0.7	0.8	2.3	0.7
2024	0.8	0.7	0.6	1.4	1.0

Source: Destatis, Eurostat, KfW Research

Forecast risks are overwhelmingly on the downside

Besides the military and geopolitical risks created by Russia's invasion of Ukraine, developments in the energy markets continue to be the greatest imponderables of the economic forecast. It is assumed that the gas price will move along the current forward rates. In other words, starting from the current spot price of around EUR 30 on average in the first half of August, a moderate increase to approx. EUR 50 per MWh is expected from autumn 2023 to the end of 2024. If all gas supplies from Russia to the EU are stopped or the winter of 2023/2024 is an exceptionally cold one, prices could rise much more strongly than expected and thereby worsen the outlook for real growth and inflation. Given the successes at reducing gas consumption and high storage levels in Germany, a shortage in the winter of 2023/2024 is now quite unlikely but still possible, especially in the event of a disruption of piped supplies from Norway, for example through an act of sabotage.

Uncertainties also remain about the impact of monetary tightening. For one thing, the transmission of monetary policy impetus to the real economy and, in particular, inflation, is slow and its scale is hard to predict, creating the possibility of over-tightening or under-tightening by central banks. For another, the turbulence in the US banking system in the spring of 2023 demonstrates that a rapid interest rate reversal may lead to undesired side-effects. According to the ECB's Financial Stability Report, European banks have mostly hedged their interest risks and are also capitalised well enough to absorb rising loan defaults. But it is possible that yet undetected fracture points open up in the financial system.

Furthermore, inflation could even prove to be more persistent than we expect regardless of the impact of monetary policy. Thus, wage increases could turn out even higher than we assume or, unlike before, households could resort to spending the significant excess savings they accumulated during the pandemic. Both would contribute to significantly higher consumption and economic growth but would likely also lead to even tighter monetary policy which, for its part, could cause sharp corrections to the values of assets such as real estate and problems in the financial system.

Finally, because of its close integration into international value chains and its high share of exports in GDP, the German economy remains particularly vulnerable as soon as geopolitical risks materialise. Thus, a sharp reduction in trade with China, for example in connection with the war in Ukraine or the Taiwan conflict, could lead to significant losses, particularly for manufacturing. Moreover, any escalation of the problems in China's property market, which have been simmering for a long time, into a deeper economic crisis poses a risk to global growth.

[1] Cf. Scheuermeyer, P. (2023), Wettbewerbsfähigkeit nach dem Gaspreisschock: Auf Energiepreise und Effizienz kommt es an (*Competitiveness after the gas price shock: energy prices and efficiency are what matters* – in German), Focus on Economics No. 434, KfW Research.

[2] Cf. Borger, K. (2022), GDP forecasting and greenhouse gas emissions – an integrated approach, Focus on Economics No. 400, KfW Research.