Recession has merely been put off for a bit

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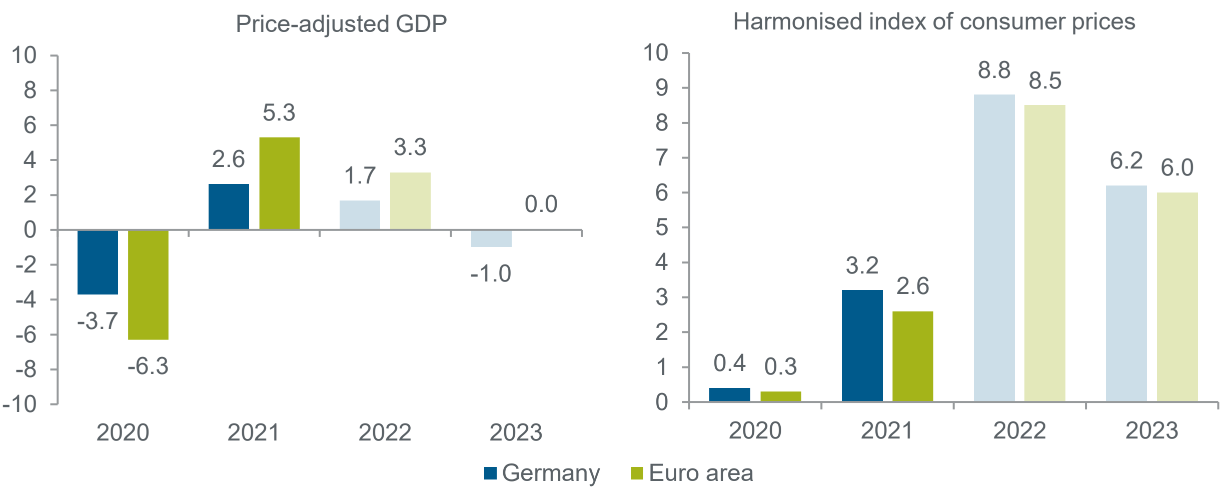
Authors: Dr Klaus Borger, +49 (0)69 7431-2455, klaus.borger@kfw.de
Dr Jens Herold Esteves, +49 (0)69 7431-9385, jens.herold_esteves@kfw.de
Dr Philipp Scheuermeyer, +49 (0)69 7431-4017, philipp.scheuermeyer@kfw.de
Stephanie Schoenwald, +49 (0)69 7431-6446, stephanie.schoenwald@kfw.de
Press contact: Christine Volk, +49 (0)69 7431-3867, christine.volk@kfw.de

– Dwindling purchasing power, enormous uncertainty, rate hikes and a weak global economy are weighing on economic activity. After summer growth driven by catch-up-up effects in consumer spending, Germany's economy will slide into recession in Q4 2022.
– KfW Research expects Germany's GDP to grow by 1.7% in 2022 but shrink by 1.0% in 2023 (previous forecast: +1.4% and -0.3%). Forecasting risks have become much larger than usual due to the multiple crisis with war in Ukraine and the coronavirus pandemic.
– The very steep rises in energy prices due to the war are increasingly filtering through to other goods. Germany's inflation rate will therefore be a very high 8.8% in 2022 and only dip to 6.2% on average across the year 2023.
– A novelty – an Ecological Price Tag for GDP: Although Germany's greenhouse gas emissions will decrease with the predicted economic performance, the decline is estimated to remain 6% (2022) and 5% (2023) below the policy target.
– The euro area economy will benefit more strongly than Germany from the recovery of tourism and the smaller manufacturing share. Its GDP will grow by 3.3% in 2022 and stagnate in 2023. Inflation there will stand at 8.5% and 6.0%, respectively.

Figure 1: Economic growth and inflation

Per cent year-over-year change



Source: KfW Research, Destatis, Eurostat

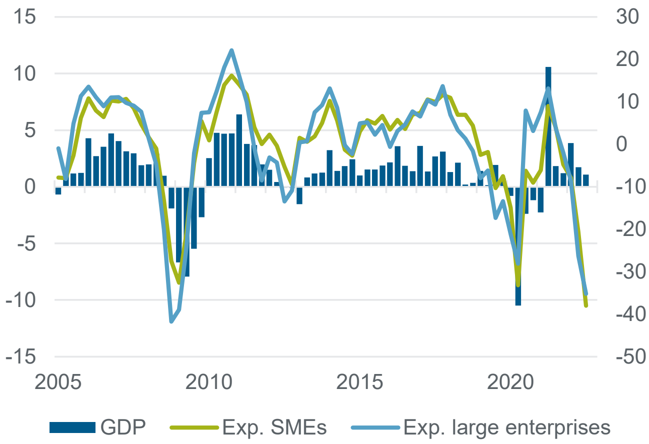
Short-lived growth sprint in third quarter

In spite of the multiple pressures from the Russia-Ukraine war, the energy markets, purchasing power-depleting inflation, the still not fully overcome coronavirus pandemic and the persistent global supply chain problems, the growth rate of gross domestic product (GDP) – adjusted for price, seasonal and calendar effects – accelerated from 0.1% in the second quarter to 0.4% in the third quarter of 2022. This brief summer growth sprint came as something of a surprise because important promptly available economic indicators had previously pointed to a GDP contraction on the previous quarter. For example, business situation assessments surveyed as part of the KfW-ifo SME Barometer deteriorated very significantly on the previous quarter (SMEs -5.8 points; large enterprises -6.1 points)[1], and the EU consumer confidence indicator for Germany plummeted to a new historic low.[2] Nonetheless, it was household consumption that, according to Destatis, increased by 1.0% and thus contributed the lion's share to quarterly growth, even though retail turnover excluding motor vehicles as a key goods consumption indicator shrank at the same time (-2.1% in real terms). This suggests that services consumption, which was significantly restricted primarily during the peak periods of the coronavirus pandemic, was an important driver again in the third quarter, probably because of significant pent-up demand. Furthermore, the processing of orders backed up in the automotive industry, where material bottlenecks have now eased slightly on a high level, is likely to have contributed as well. Evidence of this are new motor vehicle registrations, which in September were 14% higher year on year.[3] Motor vehicles represent 36% of durable goods consumed by households and 4.2% of total private consumption expenditure. Both demand impulses are of a temporary nature, and from the final quarter onwards the short-lived growth sprint will likely be replaced by a contracting economy.

Business expectations are very bleak

The conditions for the further course of consumption, but also for investment, are basically unfavourable. Irrespective of the energy price caps for gas, district heating and electricity, households as well as businesses will have to prepare for significantly higher energy costs and, since pressure from energy costs will filter through to other consumer goods along the value chain, especially food, much higher living costs overall compared with the previous years (see section below 'Inflation pressure is falling only slowly'). After the pent-up demand in services consumption has run its course and the excess savings from the pandemic lockdown periods have been depleted, this will lead to declining household consumption expenditure in real terms in 2023. On the production side, energy costs are a burden, particularly on energy-intensive manufacturing industries. The global economic environment has also dimmed considerably, reducing demand for German export goods. For 2023 we expect global economic growth of just 2.4%, which is less than the customary threshold value below which a global recession is typically identified (2½ to 3%). Exceptionally high inflation rates are also depleting purchasing power around the world, and the central banks of globally important economies are pursuing a course of rapid monetary policy tightening which is putting the brakes on consumption and investment demand. In the business surveys, the forward-looking components such as the business expectations reported under the KfW-ifo SME Barometer are very pessimistic. In both enterprise classes they have dropped to levels previously seen only before the major recessions (see Figure 2).

Figure 2: KfW-ifo business expectations and GDP growth
GDP: Per cent on previous year's quarter, adjusted for price effects (left scale)
Expectations of SMEs/large enterprises: Balance points (right scale)



Source: Destatis, KfW Research

We estimate that amid the war in Europe, price and cost upsurges not seen for decades, the looming geo-economic fragmentation and the coronavirus crisis, the grim sentiment is being driven to an unusual degree by the plethora of omnipresent risks and less by the businesses' individual expectations than has previously been the case. The strong and persistent pessimism, however, combined with enormous uncertainty, inflation-induced purchasing power losses, higher interest rates and tightening borrowing conditions, will likely weigh on private investment activity and, despite positive impetus from energy transition projects, create considerable reluctance to invest not just in the enterprise sector but in residential construction as well. Only in the public sector is investment likely to rise in 2023, especially as the money allocated to the new special fund for the German Armed Forces will boost public defense spending.[4]

Germany is sliding into recession in the fourth quarter

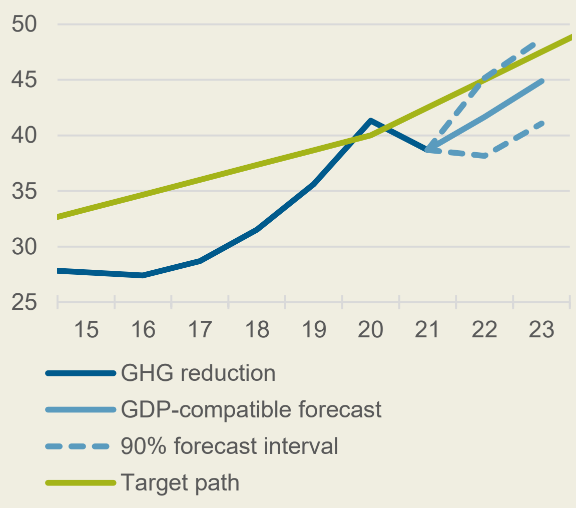
On balance, we expect clearly negative quarterly growth rates of at least half a per cent for the winter half of 2022/2023 and a return to growth not before the summer of 2023. Until then, energy-intensive industries are likely to have made noticeable progress in modifying their production, and higher nominal wages combined with slightly lower inflation rates will at least mitigate the real income losses of households. Subsequently, however, refilling the natural gas storage tanks again – this time without Russian pipeline gas – for the winter of 2023/2024 will likely involve some challenges, which is why the expected economic recovery in the course of the coming year will probably be rather modest. All in all, thanks to the solid growth rates in the first three quarters, Germany's GDP will grow by a total of 1.7% in 2022 but is set to contract by -1.0% in 2023.[5] With the revisions made in our autumn forecast, our updated economic projection has now turned out somewhat more pronounced than in the preceding summer forecast. In August we had expected 1.4% growth for 2022 and -0.3% for 2023.

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. Therefore, the time has come to focus more comprehensively and rigorously than before on the consequences of economic activity, particularly for the environment and climate. To this end we have developed a simple approach for systematically integrating the expected greenhouse gas (GHG) emissions into our economic forecast for Germany.[6] 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 level by 2030. 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 will put 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 indicator predicts that emissions will drop this year and next, but less than intended (see Figure 3).

Figure 3: GHG emissions in Germany

Reduction against 1990 level in per cent



Source: Destatis, Eurostat, KfW Research

Thus, Germany's GHG emissions are predicted to be around 42 million t CO_2 equivalent or a good 6% higher 2022, and around 33 million t CO_2 equivalent or 5% higher in 2023 than prescribed by the reduction trajectory set by policymakers (see Table 1). The average additional emissions of a good 37 million t CO_2 equivalent forecast for each year are equal to the total emissions of Slovakia in the year 2020.

Table 1: GHG emissions and policy trajectory

Million tonnes of CO_2 equivalents

	2020	2021	2022	2023
Actual/forecast	729	762	725	685
Target path	745	714	683	652
Actual/forecast deviation from target path				
Absolute	-16	47	42	33
Percent	-2.2	6.6	6.1	5.0

Source: Destatis, Eurostat, KfW Research

Like all forecasts, this one, too, is fraught with uncertainty. With reference to the 90% forecast interval presented in Figure 3, 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.

In qualitative terms, we nonetheless rate the recession in the coming year as moderate, particularly as compared with the declines in GDP in the preceding crisis years (financial crisis 2009: -5.7%; coronavirus crisis 2020: -3.7%) and in contrast to the very bleak expectations held out by businesses. Another reason for classifying the beginning recession as moderate is that in the face of worsening shortages of skiled labour, businesses will seek to retain their workers wherever possible, which is why a nearly steady labour market can be expected next year despite declining economic output. At the same time, the pressure to take action on climate change will remain high. According to our new indicator, the Ecological Price Tag for GDP, our current economic forecast implies that greenhouse gas emissions this year and next will be 6% and 5% higher, respectively, than would correspond with the interpolated target trajectory of a 65% reduction by 2030 against the 1990 baseline (see box).

Inflation pressure in Germany is falling only slowly

With the end of the 9-euro ticket and the fuel tax rebate at the end of September 2022, Germany's inflation has resumed its upward climb again. Measured against the change in the EU-wide comparable Harmonised Index of Consumer Prices (HICP) on the previous year, it rose from 8.8% in August to 10.9% in September and further to 11.6% in October. It is forecast to sit at 8.8% on average for the year 2022. Besides energy prices, food prices in particular are contributing to the high inflation rate. However, the reported monthly inflation rate is likely to drop again in the course of 2023 as base effects from the previous year will reduce the contributions from energy and food price inflation, and the price caps on natural gas, district heating and electricity will also mitigate the rise. However, the drop in the inflation rate will remain only gradual at first because the price surges for goods at the beginning of the value chain as, in particular, energy will continue filtering through to the downstream production stages and at least partly shape the coming collective wage settlements. As wages and prices of services are then likely to increase more strongly against thr backdrop of the widespread skills shortages, this will keep the pressure high on the core inflation rate – that is, inflation without energy and food prices. In the medium term, however, the recession and the European Central Bank's tighter monetary policy will also dampen core inflation. For 2023 as a whole, we expect consumer prices to rise by 6.2%

on average, again clearly missing the monetary policy target of 2%.

Euro area will grow by 3.3% in 2022 and stagnate in 2023

The euro area is generally subject to the same economic forces as Germany; inflation-induced purchasing power losses and energy price-related cost pressures on businesses are considerable everywhere. Still, the large euro countries France, Italy and Spain in particular benefited from the strong recovery in tourism in the summer half-year. Moreover, having a manufacturing sector with a smaller economic weight is an economic advantage in the current situation, especially when it is less dependent on international value chains and Russian natural gas supplies.

Table 2: 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	-11.3	-6.3
2021	2.6	6.8	6.7	5.5	5.3
2022	1.7	2.5	3.8	4.7	3.3
2023	-1.0	0.2	-0.4	0.9	0.0

Source: Destatis, Eurostat, KfW Research

Now that the catch-up growth in tourism has largely ended, headwinds will dominate here as well and lead to a technical recession (that is, at least two consecutive quarterly GDP contractions) in the euro area in the winter half-year of 2022/2023. But since growth in the first three quarters was better than previously expected, we nonetheless lift our forecast for 2022 to 3.3%, while we now expect only stagnation for 2023 (previous forecast: +3.0% and +0.5%). Germany and Italy, with their relatively important industrial sectors, will perform the worst of the large euro area countries in 2023 (see Table 2). We expect the average annual euro area inflation rate to sit at 8.5% in 2022 and 6.0% in 2023, just slightly below the rate in Germany.

The war and further risks

Among the risks, the Russia-Ukraine war is currently the most important factor creating enormous forecasting uncertainty. What impacts it will have on the economy depends on how long the spiral of sanctions and escalation continue to turn, but also on the intensity and duration of the war. Of particular economic relevance is whether there will be a gas shortage that makes energy rationing necessary, particularly in industry. A resulting deep recession would also likely tip the hitherto steady German labour market. Given that the gas storage facilities were completely full in November and industrial firms and households have achieved remarkable savings, such a development is now very unlikely but in principle still possible, especially if the winter turns out to be unusually cold. Should a wage-price spiral become apparent, monetary policy in the euro area and around the world might be tightened even further than expected. Given that many countries are now forced to consolidate their finances, that, in turn, could lead to increased financial stress and a correction in the valuation of assets, including real estate, through tougher international financing conditions. The Deutsche Bundesbank has warned that dwellings in German cities were already 15% to 40% overpriced in 2021, so that there is the risk of abrupt price corrections in the real estate market as a result of rising interest costs. Along with the war, the coronavirus pandemic continues to simmer and the emergence of any further infection waves or virus mutations may lead to the imposition of new economically relevant restrictions with negative effects on the availability of materials, production and labour demand. Because of its close integration into international value chains, the importance of mechanical engineering and the automotive industry and the high share of exports in GDP, Germany's economy becomes particularly vulnerable as soon as global risks materialise. But apart from the risks, there is also the chance the economy may develop more favourably than expected. Consumption could stabilise if the savings rate drops noticeably. Besides, the substitution of Russian energy and commodities may run more smoothly than expected, for example if new abundant supply sources are quickly developed or if the transition to renewables accelerates substantially. A peaceful solution for Ukraine that is accepted by all sides would eliminate the uncertainties created by the war, give businesses much more confidence again, set reconstruction efforts in motion and thus provide new economic impetus, especially for investments and exports.

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[1] Cf. Borger, K. (2022), The recession has begun; business expectations are nearing their all-time low, KfW-ifo SME Barometer September 2022, KfW Research.

[2] Cf. European Commission, Business and consumer survey results for September 2022 – Statistical Annex.

[3] https://www.vda.de/de/aktuelles/zahlen-und-daten/monatszahlen.

[4] In opposition to the concepts applied in the federal budget plan, the national accounts treat military weapon systems as capital formation by the government, specifically as part of the government's investment in machiniery and equipment.

[5] The price-adjusted GDP growth rate forecast here is primarily communicated in Germany. In addition to the fundamental economic drivers, however, it is also influenced by 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 corresponds to 1.8% (2022) and -0.8% (2023) on a price- and calendar-adjusted basis.

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