KfW Research
KfW Business Cycle Compass November 2023

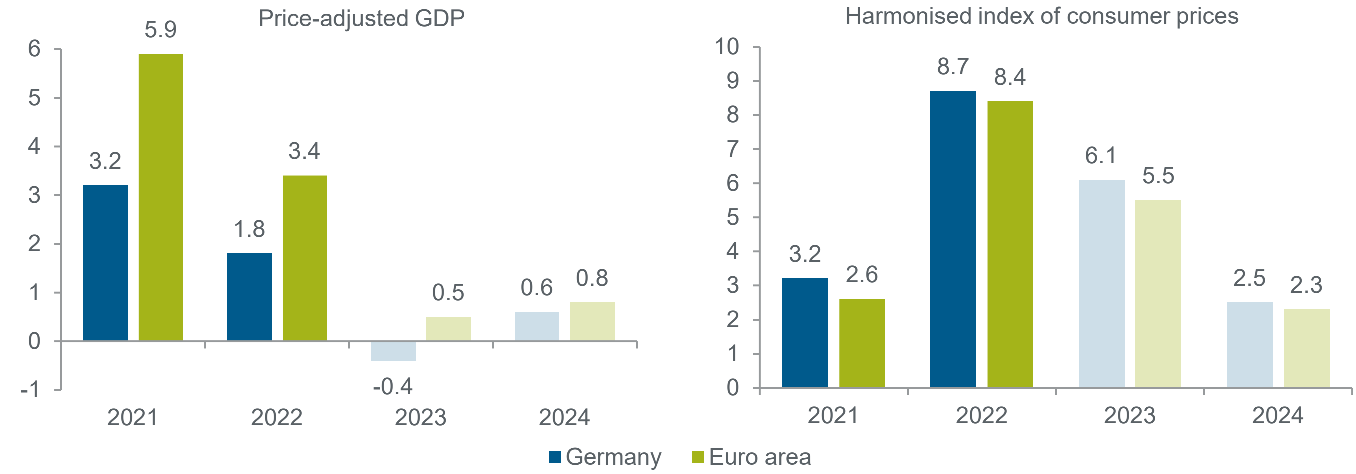
Germany's economy in 2024: a first silver lining on the horizon

24 November 2023

Authors: Dr Klaus Borger, +49 69 7431-2455, klaus.borger@kfw.de
Dr Jenny Körner, +49 69 7431-57189, jenny.koerner@kfw.de
Dr Philipp Scheuermeyer, +49 69 7431-4017, philipp.scheuermeyer@kfw.de
Stephanie Schoenwald, +49 69 7431-6446, stephanie.schoenwald@kfw.de
Press contact: Christine Volk, +49 69 7431-3867, christine.volk@kfw.de

- The German economy has been more or less treading water so far this year. Business investment is recovering on a low level but consumption is still suffering from purchasing power losses and exports from a weak global economy.
- KfW Research expects the German economy to contract slightly in 2023 (-0.4%; confirming previous forecast) and then return to moderate growth in 2024, thanks primarily to a recovery in real wages and, hence, consumption (+0.6%; previous forecast +0.8%).
- 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 around 5% in both 2023 and 2024.
- At 3.0% (HICP), German inflation in October was the lowest it has been since July 2021. A favourable base effect for energy in particular is currently driving a rapid decrease. As businesses have limited scope for enforcing price increases in a moderate economic environment, the downward trend is likely to continue. KfW Research continues to forecast an inflation rate of 2.5% for 2024 (6.1% for 2023).
- The euro area has hardly been growing in the second half of 2023 and the expected economic recovery has been delayed to next year. Its GDP will likely grow by 0.5% in 2023 and by 0.8% in 2024. We expect 5.5% inflation this year and 2.3% next year.

Figure 1: Economic growth and inflation
Per cent year-over-year change



Sources: KfW Research, Destatis, Eurostat

So far, the German economy is treading water

Adjusted for price, seasonal and calendar variations, the quarterly growth rates of gross domestic product (GDP) have been closely hugging the zero line so far this year and, according to the most recent figures, the economy shrank by 0.1% in the third quarter on the previous quarter. The renewed decline in household consumption expenditure in the summer (-0.3%) underscores the fact that the aftereffects of the inflationary surge caused by supply shortages and the energy price explosion as well as resulting purchasing power losses are still being felt. By contrast, business investment has grown considerably so far this year, likely bolstered by catch-up effects after the deep slump during the COVID-19 pandemic and by investments in vehicle fleets prior to the expiry of government subsidies for the purchase of electric vehicles at the end of August 2023.[1]

Stagnation will continue in final quarter

Based on the KfW-ifo SME Barometer for October, business sentiment steadied at the beginning of the fourth quarter but remains on a low level.[2] The dissolution of the two negative supply shocks of the past year had a stabilising effect. Material shortages in manufacturing and construction faded into the background and the prices for fossil fuels have embarked on a downward trend, which is now pushing consumer price inflation down as well. Still, the situation remains difficult, especially for the industrial sector. Manufacturers are feeling global demand weakness irrespective of continuing above-average order volumes, while construction – particularly dwellings – remains under considerable pressure as a result of rapid interest rate and construction cost increases. All in all, economic activity can be expected to more or less stagnate again in the final quarter of 2023.

German GDP to shrink by 0.4% in 2023

Even if GDP will thus roughly stagnate across the year 2023, we expect real growth in Germany to be a negative -0.4% in 2023 as a whole, confirming our previous forecast. Two statistical effects play a decisive role in this. In the final quarter of 2022, GDP had dropped significantly against the background of a feared energy crisis following the Russian gas supply stop and considerable inflation-induced purchasing power losses (-0.4%). The contraction at the end of the previous year caused this year's economic growth to start from a level that was 0.2% lower than the average across all four quarters of 2022. This shortfall – known as statistical underhang – would have to be balanced out first in the course of 2023 before generating any growth at all in 2023 on the previous year. Furthermore, the year 2023 has two fewer working days on which to generate GDP than 2022, which in itself reduces annual growth by around 0.2 percentage points as a negative calendar effect.

Return to moderate 0.6% growth in 2024

In the year that lies ahead, however, the German economy will return to moderate growth and we expect slightly increasing quarterly rates from the spring. As in our previous forecast from August, our prediction rests primarily on a revival of household purchasing power, which will drive consumption in the course of the coming year. But as we now expect consumption to begin recovering somewhat later than we predicted in the summer, because the renewed contraction in the third quarter has made us more cautious, we have revised our forecast for 2024 downward slightly to 0.6% (previous forecast +0.8%).[3] The return to at least moderate growth is, after all, a first silver lining on the horizon, considering the numerous crises and great challenges.

Pressure to act on climate change remains high

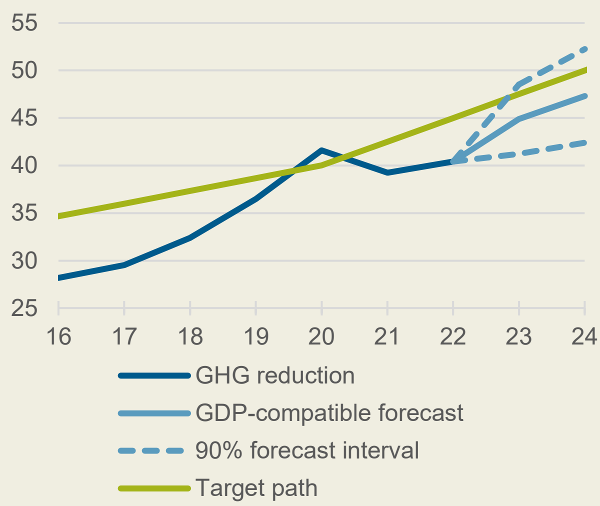
In the medium to long term, transitioning the economy and society to carbon neutrality will likely be the greatest of these challenges as the pressure to take action on climate change remains high. According to the ecological price tag for GDP, the new indicator we introduced last year, our current economic forecast implies that greenhouse gas emissions this year and next will be around 5% higher 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 heating poses a threat to the natural bases of human life and, thus, to economic activity. It is therefore high time to focus more comprehensively and rigorously than before on the impact of economic activity on the environment and climate in particular.

Figure 2: GHG emissions in Germany

Reduction against 1990 baseline in per cent



Source: Destatis, Eurostat, KfW Research

To this end we have developed a simple approach for systematically integrating the expected greenhouse gas (GHG) emissions into our economic forecast for Germany. 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 2). 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 34 million t CO_2 equivalent or a good 5% 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 Lithuania's and Estonia's combined total emissions in 2021 (20+13=33 million tonnes of CO_2 equivalent).

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

	2020	2021	2022	2023
Actual/forecast	760	746	690	659
Target path	719	688	657	626
Actual/forecast deviation from target path				
Absolute	41	57	33	34
Percent	5.7	8.3	5.0	5.4

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 will be missed in the forecast period appears to be empirically sufficiently well validated.

Inflation is approaching the target

Relatively good progress was achieved in the fight against high inflation in recent months, both in Germany and in the euro area. In October the German inflation rate fell to just 3.0% as measured by the annual variation of the Harmonised Index of Consumer Prices (HICP). In August it still stood at 6.4%. This rapid decrease was supported by strong base effects. Energy prices for consumers had reached their maximum for the time being in autumn of last year. The situation in the energy markets has since eased. Negative contributions of energy prices to inflation are therefore significantly reducing the overall rate. However, this tailwind will weaken in the months ahead. It is therefore all the more important that price increases have also slowed in the remaining groups of goods (food, industrial goods excluding energy, services). There is much to indicate that this easing price pressure will continue broadly next year. Producer prices for industrial goods (excluding energy) and agricultural products are now rising only slowly or even falling on the previous year. The picture is similar for imported products. How quickly price stability will return, however, will be decided in the all-important services sector. That is where stronger wage growth in particular is putting pressure on costs. The merely moderate economic recovery being expected, however, is likely to restrict businesses' scope to pass costs on to consumers. There are already first signs that upward pressure on wages is weakening again. Employers recently offered much lower salary increases for vacancies advertised on the job board Indeed. We therefore confirm our forecast of 2.5% inflation on average for Germany in 2024. That would be a sharp drop on the predicted consumer price increase of 6.1% for this year. However, given the geopolitical situation, there is an increased likelihood of new supply-side shocks, particularly in energy markets. If they were to materialise, inflation could receive another boost. It would also end up higher if the revival in demand were to turn out stronger than anticipated.

A closer look at the key economic drivers

Consumption is set to recover thanks to rising real wages

The two consecutive years of declining real wages came to an end in the second quarter of 2023 (+0.1% on the same quarter of the previous year) because higher nominal wage growth (+6.6%) was met with continuing high but declining inflation (+6.5%).[4] This development will continue in the forecast period and drive accelerated real wage growth, thanks particularly to further falling inflation. We expect collective wage increases of around 5% in 2024, while consumer price inflation will probably ease to 2.5%. At the same time, employment is likely to rise moderately to 46 million people on average for 2024, while the unemployment rate will remain roughly on the level of 2023 as skills shortages deepen. Rising real wages and steady employment will also let the wage sum rise tangibly in real terms, giving households added purchasing power which they can use for consumption purposes. Furthermore, additional impetus to consumption could come from a falling saving rate, which was still slightly above the pre-crisis level despite the considerable buildup of savings during the COVID-19 pandemic. All in all, we therefore anticipate that unlike this year, private consumption expenditure will grow again significantly and bolster the economy in 2024. Real public sector consumption expenditure can also be expected to see a reversal to a positive annual variation rate. In the first quarter of 2023, it had fallen by around 2% on the previous quarter with the end of pandemic-related measures such as COVID-19 tests and vaccination centres and has since hovered on a lower level. This special effect will be absent next year.

Monetary policy is slowing residential construction in particular

Construction investment, particularly in housing, can be expected to continue decreasing, since that is where the sharply higher financing costs resulting from the European Central Bank's interest turnaround are felt particularly acutely. This is compounded by persistently high construction costs despite significantly easing supply bottlenecks and high prices of land resulting from a decades-long upward movement. Although new orders in the main construction industry have stabilised since July, in the months available so far (January to August) they were still almost 8% below the corresponding level of the previous year.[5] New building permits even plunged by a good 38% overall up to and including September.[6] At the same time, energy upgrades and the volume of orders that has accumulated in the years up to 2022 stabilise construction investment. The overhang of approved but unbuilt dwellings stood at a record 885,000 units at the end of 2022. It would take around two to three years to eliminate it, provided the majority of approved homes are actually built. The construction sector is only likely to see a trend reversal after the end of the forecast period as financing costs will probably decrease up until 2025 and the price of land is likely to fall moderately. For 2024, on the other hand, a renewed decrease in residential construction in real terms and in gross value added in the main construction industry can be expected at least on the average for the year.

Business investment stays on a growth trajectory

According to the Deutsche Bundesbank's Bank Lending Survey of October[7], the general interest rate level is the main reason that businesses have applied for fewer loans since the end of last year. The monetary policy-induced interest rate increase and bleak business expectations are weighing on corporate investment, to be sure. Nonetheless, it will grow both this year and next. Impetus should come from the ongoing catch-up process after the steep decline in the COVID year 2020. After all, unlike GDP, which now slightly exceeds the pre-COVID level of the final quarter of 2019, business investment has since made up for only part of the slump, remaining around 2% below that level last spring. There is an urgent need for investment, especially around the energy transition, climate neutrality and digitalisation, which can be tackled more vigorously now that the capital goods manufacturers that were paralysed by supply chain disruptions are sufficiently able to deliver again. The consumption-driven economic recovery is likely to additionally bolster investment next year as increasing production capacity utilisation will then make it more attractive. Public-sector investment is also set to expand significantly, driven not just by high infrastructure requirements but likely also by rising expenditure on military weapons systems.

A recovery is on the cards for exports and industry in 2024

As a global leader in the manufacture of capital goods, German industry is being slowed down considerably by global monetary tightening and a sluggish Chinese economy that is lumbering under the property crisis, while price competitiveness remains a particular challenge for energy-intensive industrial sectors. Thus, new manufacturing orders fell by 6.8% in the first nine months of this year on the same period last year, with orders from outside Germany alone dropping by 6.6%. The stock of orders, however, remains unusually high. In September it was still almost one fifth above the historic average and can at least partly offset the decline in new orders.[8] But German exports will probably decrease in 2023 nonetheless. However, since imports are likely to decrease even more strongly as a result of weak domestic demand, net exports – the balance of exports and imports, relevant for the calculation of growth – will likely make a positive contribution to the annual GDP variation rate this year. Next year it is likely to be the reverse, even if we expect the global economy to grow at a similarly sluggish rate of 2.9% as this year, for which we predict 3.0%. What is decisive is that the volume of global trade is likely to expand again at a rate comparable to the global economic growth rate in 2024, after probably remaining well below it in 2023, since this year's growth is taking place primarily in the services sector. As global price pressure eases, Germany's trading partners are increasingly regaining purchasing power while the dampening effect of monetary tightening weakens slightly and the global post-pandemic boom in services comes to an end so that more resources will be freed up again for the consumption of goods. Export demand for German industrial goods can therefore be expected to pick up. But since the likewise expected consumption-driven recovery in Germany will also cause import demand to grow noticeably, net exports may even slightly reduce real GDP growth in 2024.

Euro area will grow by 0.5% in 2023 and 0.8% in 2024

In France and Spain, the gains in household purchasing power enabled by falling inflation and rising nominal wages appear to be bearing the first fruit. A moderate recovery in consumption in the third quarter contributed to growth in these economies. In Italy, however, as in Germany, the hoped-for effect from easing inflationary pressure failed to materialise for now. Overall, the euro economy contracted by 0.1% in the third quarter after growing by 0.2% in the second quarter. Irrespective of the recent positive trends in Spain and France, the muted consumer confidence indicators in the euro area suggest that the expected consumption impetus is delayed until next year. On the origin side, the purchasing manager indexes in October[9] continue to show a low level of activity for manufacturing and services. At the same time, increased credit costs are hampering economic activity, as illustrated by continuing weak credit demand from households and businesses. We therefore expect only stagnation in the fourth quarter for the euro area overall, which puts real growth at 0.5% for all of 2023 (previous forecast +0.7%). We expect inflation to sit at 5.5% this year. The generally low growth in the euro area is caused not just by the decline in Germany but also by exceptionally weak performance in the smaller euro countries. For the coming year we predict 0.8% growth for the euro area (previous forecast +1.0%) and 2.3% inflation. As in Germany, the steady employment situation and real wage increases are key to providing a consumption impetus that will unfold as inflation continues to fall. The discontinuation of fiscal policy support measures during the energy crisis and the surge in inflation, on the other hand, will in themselves dampen economic growth. Among the four large countries, we expect Spain and France to achieve the highest growth rates (see Table 2), with both countries also benefiting from economic tailwind from the previous year. The expected slowdown in growth in Spain is driven by the further weakening growth contribution of tourism, which made up a lot of lost ground in 2021 and 2022 again after the steep decline during the COVID-19 crisis, so that growth in tourism will again be more moderate as the catch-up process comes to an end. We expect Italy to grow only at a slow pace next year as construction subsidies expire.

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	8.3	6.4	5.9
2022	1.8	2.5	3.7	5.8	3.4
2023	-0.4	0.9	0.7	2.4	0.5
2024	0.6	0.9	0.4	1.4	0.8

Source: Destatis, Eurostat, KfW Research

Economic forecast: many risks …

Besides geopolitical and geoeconomic risks in connection with Russia's invasion of Ukraine, the Middle East conflict and tensions between China and Taiwan, shortages and abrupt price increases in the energy markets remain among the greatest imponderables of the economic forecast. If all gas supplies from Russia to the EU are stopped or the winter of

2023/2024 turns out exceptionally cold, 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 the high storage levels in Germany, a shortage in the coming winter 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 uncertain, 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 definitely possible that as yet undetected fracture points opened up in the financial system in the course of the prolonged low-interest phase. 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 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. Another downside risk for the economic forecast is posed by fiscal policy, which may now become more restrictive as a result of the Federal Constitutional Court's ruling on the Climate and Transformation Fund and the associated reduced reliability of the framework for business activity. At global level there is a risk that the crisis in China's property sector may get out of control and cause an economic slump there, with negative spillover effects, particularly in the region and for commodity exporters. Besides, increasing geopolitical conflicts may lead to a fragmentation of the global economy. Germany's close integration into complex international value chains and high openness to international trade make the country particularly vulnerable as soon as these risks materialise. Finally, environmental and natural disasters including extreme weather events such as floods and droughts, which are becoming increasingly more likely as a consequence of climate change, can have an unforeseen impact on the predicted economic development.

… but some opportunities, too

Apart from the risks, there is also the chance the economy may develop more favourably than expected. If global inflation falls faster than expected and interest rates can also be reduced sooner as a result, that will benefit Germany's economic performance in particular. After all, Germany specialises in the manufacture and trade of interest rate-sensitive capital goods.

---

[1] Borger, K. (2023), Unternehmensinvestitionen 2023: trotz Anstieg noch unter Vor-Corona-Niveau (Business investment in 2023: still below pre-COVID level despite rise – in German only), Economics in Brief No. 241, KfW Research.

[2] Scheuermeyer, P. (2023), KfW-ifo SME Barometer October 2023, KfW Research.

[3] Unlike in 2023, the calendar effect next year is negligible, and our current forecast provides for only a mild statistical underhang in the quarterly profile of 2023.

[4] Reallöhne im 2. Quartal 2023 um 0,1 % höher als im Vorjahresquartal – (*Real wages in second quarter of 2023 0.1% higher than in the same quarter of the previous year* – our title translation, in German) Federal Statistical Office (destatis.de).

[5] Auftragseingang im Bauhauptgewerbe im August 2023: +10,8 % zum Vormonat (*New orders in the main construction industry in August 2023: +10.8% on previous month* – our title translation, in German only) – Federal Statistical Office (destatis.de).

[6] Baugenehmigungen für Wohnungen im September 2023: -29,7 % gegenüber Vorjahresmonat (*Building permits for dwellings in September 2023: -29.7% on the same month a year earlier* – our title translation, in German only) – Federal Statistical Office (destatis.de).

[7] Bank Lending Survey - net shares (bundesbank.de).

[8] Manufacturing in September 2023: stock of orders -0.8% on the previous month - Federal Statistical Office (destatis.de).

[9] HCOB Flash PMI Eurozone (spglobal.com).