All is not lost that is delayed!

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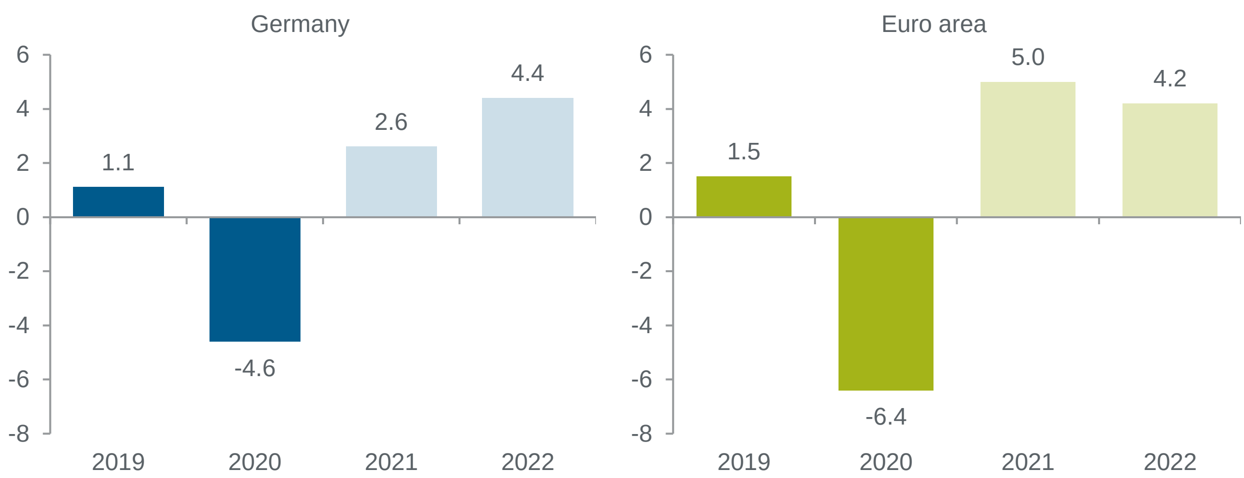
– In the third quarter, catch-up effects in contact-intensive services drove fairly strong GDP growth of 1.7% in Germany, defying persistent supply bottlenecks in manufacturing. Euro area GDP even grew by 2.2%.
– Supply bottlenecks are set to continue through the winter, while the record-high fourth coronavirus wave is again weighing on the services sector. The German economy will therefore hardly move beyond stagnation in the winter half of 2021/2022.
– Quarterly growth will gain traction again from the spring. The backlog of industrial orders will lead to significant output growth as bottlenecks subside. As the pandemic is contained, services consumption will also pick up again.
– KfW Research expects German GDP to grow by a much stronger 4.4% (previous forecast of August +4.2%) in 2022 compared with 2.6% in 2021 (previous forecast +3.0%). GDP will exceed the pre-crisis level in the second quarter of 2022.
– The euro area will achieve very strong catch-up growth of 5.0% in 2021 (previous forecast +4.7%), nearly offsetting the much sharper drop many countries experienced compared with Germany at the beginning of the coronavirus crisis. Output will grow by 4.2% in 2022 (previous forecast +4.3%).
– As Omicron shows, the pandemic remains the key risk. Renewed broad lockdowns or failure of the manufacturing sector to recover would significantly weigh on growth in 2022. Still, how likely such scenarios are remains entirely unclear.

Figure 1: Growth of gross domestic product in Germany and the euro area
Variation on previous year in per cent, adjusted for price effects



Source: KfW Research, Destatis

German GDP grew strongly again in the summer

Adjusted for price, seasonal and calendar variations, Germany's third-quarter 2021 gross domestic product (GDP) grew by 1.7% on the previous quarter and thus nearly as vigorously as in the second quarter, for which the German Federal Statistical Office recently revised the growth rate upwards by 0.1 percentage points to 2.0%. Measured against the 0.3% average quarterly growth rate since unification, these exceptionally high rates underscore the potential of the German economy to recover as soon as the inhibiting factors of the coronavirus crisis subside. Without the unexpectedly persistent supply bottlenecks, which led to a 2.2% drop in gross value added in the manufacturing sector despite record-high and until recently growing order volumes, the growth rate in the summer could even have turned out significantly higher. Quarterly GDP growth was driven by catch-up effects in demand for contact-intensive services, in other words, social consumption. For example, after most of the coronavirus-induced restrictions were lifted, people went out dining or visited cultural or sporting events more often, undertook more domestic trips owing to continuing travel warnings or quarantine regulations and purchased more personal services again. As a result, private consumption drove quarterly growth practically on its own and, with a growth rate of 6.2% (growth contribution: +3.0 percentage points), it more than offset the declines of the other components.

Stagnation in the winter half of 2021/2022

After the growth surge of the summer, which was driven by consumption of services, the economy will hardly grow beyond stagnation in the winter half of 2021/2022 and may even temporarily contract a bit. The steep rise in energy prices is bringing household purchasing power down (consumer price inflation rate in November: +5.2%) and putting cost pressure on businesses. At the same time, raw material bottlenecks and input shortages, as well as disruptions to the global transport system, remain persistent. In the November survey of the ifo Institute, a good 74% of manufacturers deplored a scarcity of inputs, four percentage points more than in October. Above all, the automotive and mechanical engineering industries, which are important for Germany, continue to be disproportionately affected (88 and 86%). These supply disruptions will ease only gradually and are now affecting commerce as well. According to the ifo Institute, 60% of retailers reported problems securing a sufficient supply of goods in October, which will have consequences for the choice of products in Christmas trading. To make matters worse, with the start of the cold season, the fourth wave of COVID-19 infections continues to climb to new highs amid insufficient vaccination rates. Policymakers are absolutely intent on preventing renewed broad lockdowns, to be sure, but capacity limits, contact restrictions, entry restrictions for the unvaccinated and voluntary social consumption restraint out of fear of infection are set to weigh on turnovers in stationary retail, hospitality and other affected services again in the autumn and winter.

Growth is expected to surge from next spring

But as the saying goes, all is not lost that is delayed. The gap between demand and supply in manufacturing has widened continuously since mid-2020. As of September 2021, monthly new orders in manufacturing were almost 9% higher than in February 2020, the last month before coronavirus restrictions were imposed. By comparison, output is continuing to drop as a result of severe material bottlenecks and is now a good 11% below the pre-crisis level. The backlog of orders in manufacturing, surveyed since January 2015, has therefore continuously grown to new record highs on a monthly basis already since early 2021. As this enormous order backlog is reduced, a new growth surge is foreseeable in the course of 2022 as soon as the material shortages ease. According to the ifo Institute's October survey, the manufacturing sector itself expects the supply bottlenecks to continue for another eight months on average. In our view, it is plausible for manufacturers to anticipate a noticeable improvement in the supply situation by mid-2022, as widespread price increases provide strong incentives for expanding production. Once the fourth wave of the pandemic has been contained, consumption demand will also pick up again in the course of 2022, especially since private households have considerable excess savings which will also allow them to at least mitigate losses in purchasing power due to higher energy prices. From the first quarter of 2020 to the third quarter of 2021, the domestic savings ratio averaged 5.8 percentage points above the average of the previous ten years, which amounts to combined excess savings of EUR 208 billion or 6.2% of GDP of 2020. We therefore expect that as material bottlenecks and the pandemic situation begin to ease more or less simultaneously, quarterly growth will then experience a vigorous surge from the spring of 2022.

GDP forecast for Germany: +2.6% in 2021; +4.4% in 2022

All in all, German GDP will presumably grow by a much stronger 4.4% in 2022 compared with 2.6% in 2021. In our previous forecast from August we still predicted 3.0% for 2021 and 4.2% for 2022 under the key assumption that supply bottlenecks would significantly decrease already this autumn. The risk that it might take longer has now materialised. As a result, part of the growth will shift to next year and GDP at the end of 2021 will remain slightly below the pre-crisis level of the final quarter of 2019 – by a good 1%. Given the foreseeable stagnation beyond autumn and winter, economic output is not likely to exceed the pre-crisis level until the second quarter of 2022 but will then do so quite quickly and noticeably once growth picks up again strongly, as we expect it to. The calendar effect, the growth contribution of a slightly fluctuating number of annual working days, is negligible for 2021 and will be just under -0.1 percentage points in 2022. Thus, on a price- and calendar-adjusted basis, our above forecast for price-adjusted GDP, which is primarily reported in Germany, is for 2.6% growth in 2021 and 4.5% growth in 2022.

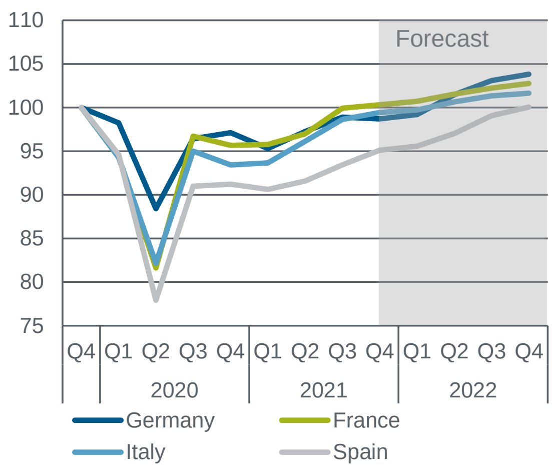
Euro area has seen an even stronger third quarter

Euro area GDP increased even more strongly than Germany's GDP in the third quarter of 2021, expanding by 2.2% on the previous quarter. The strong comeback of services, particularly hospitality and other contact-intensive sectors such as events, gave a strong boost to economic output in the euro area. At the same time, material bottlenecks weighed less on production than in Germany with its above-average share of manufacturing, including the automotive industry, which is particularly affected by the semiconductor shortage. Among the large euro countries, France grew by

3.0% in the third quarter, with the recovery of hospitality contributing half to this growth. With that, France's GDP has practically returned to the pre-crisis level (see Figure 2). At the same time, Italy grew by 2.6% and Spain by 2.0%. That is a rather modest rate given the fact that Spain's economic output had fallen much more steeply at the beginning of the coronavirus crisis than that of the other large euro countries. Apparently, tourism and consumption were less successful at recovering than initially hoped for. Thus, Spain remains the laggard of the European recovery process, with Spanish GDP still lagging a very noticeable 6.6% behind the pre-crisis level in the third quarter. For the euro area as a whole, however, the pre-crisis level is within reach – with just 0.5% to go.

Figure 2: GDP development in the four large euro countries

Adjusted for price, seasonal and calendar variations; Q4 2019=100.



Potentials for rapid improvement nearly exhausted

The potentials for rapidly improving the economic situation in the euro area have thus been largely exhausted by lifting most of the coronavirus restrictions. At the same time, the further recovery is being slowed down by an unhealthy combination of rapid energy price increases, persistent supply chain bottlenecks and local waves of infection of varying intensity. In southern Europe the pandemic situation appears to be relatively steady and manageable thanks to high vaccination rates. It is unlikely to be the source of any major disruption to the economic recovery there. By contrast, the dynamics of case numbers in Germany and other countries, especially in Northern, Central and Eastern Europe, are high. Tightening restrictions here could lead to another slight contraction in social consumption over the winter. Quarterly growth in the euro area will therefore flatten in the short term before picking up again from next spring when the pandemic situation improves and bottlenecks ease.

Euro area GDP forecast: +5.0% in 2021; +4.2% in 2022

In the final analysis, we have raised our GDP forecast for the euro area in the year 2021 to 5.0% (previous forecast: +4.7%) but slightly downgraded it to 4.2% for 2022 (previously: +4.3%). What requires some explanation is that we have upgraded our forecast for the year 2021, which is about to end, despite lowering our growth expectations for the winter half of 2021/2022 in light of the strong energy price increases, ongoing supply chain bottlenecks and the general deterioration of the pandemic situation. The main reason lies in the official revision of past growth figures, in other words, the new GDP data up to and including the second quarter of 2021, as published by Eurostat along with the result in the third quarter. That alone would result in around 0.5 percentage points more GDP growth in the euro area in 2021, meaning a higher increase than we have actually predicted. Furthermore, we wish to emphasise that the euro area growth rate which we now expect to be almost twice as high as Germany’s does not mean that the other euro countries have experienced significantly better production capacity utilisation, that is, a fundamentally better cyclical situation in 2021. Rather, GDP has had to go on a much steeper growth path in the vast majority of the other countries in order to come anywhere near offsetting the much steeper drop at the beginning of the coronavirus crisis in the year 2020. That is why the other large euro countries in particular have seen high growth rates in 2021 (see table).

Table: Price-adjusted GDP growth

Per cent year-over-year change

	Germany	France	Italy	Spain
2020	-4.6	-7.9	-8.9	-10.8
2021	2.6	6.7	6.3	4.5
2022	4.4	3.6	4.0	5.7

Source: KfW Research, Destatis, Eurostat

Coronavirus pandemic remains the main risk

The coronavirus pandemic remains the primary risk to the economy, as clearly illustrated by the newly discovered virus variant Omicron (B.1.1.529). In two crisis scenarios we estimate that Germany's growth in 2022 could turn out between 2.5 and 4 percentage points lower than we are forecasting if tighter restrictions such as broad lockdowns need to be re-imposed and, in the worst of cases, renewed global supply bottlenecks delay the recovery of the manufacturing sector further into the future. But at the moment it is completely unclear whether Omicron is indeed more infectious or causes more serious disease than the currently dominant Delta variant. Another still unanswered question is whether existing vaccines provide significantly less protection from infection with the Omicron variant. So it also remains unclear how likely these crisis scenarios are. What is also conceivable is that Omicron is more transmissible but causes much less severe disease than previous variants, which would even bring us one step closer to the end of the pandemic.