Upswing with risks

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– Germany's economic output shrank by 0.3% in the fourth quarter of 2021 under significant pressure from the difficult pandemic situation on several services sectors. Euro area GDP, on the other hand, grew by 0.3%.

– The year got off to a bad start due to the Omicron wave. Despite the current easing of restrictions in Germany and several other euro countries, growth in the current quarter is set to be weak at best.

– Quarterly growth will gain traction again from the spring. Industrial orders on hand will lead to significant output growth as bottlenecks subside. As restrictions continue to be lifted, services consumption will pick up as well.

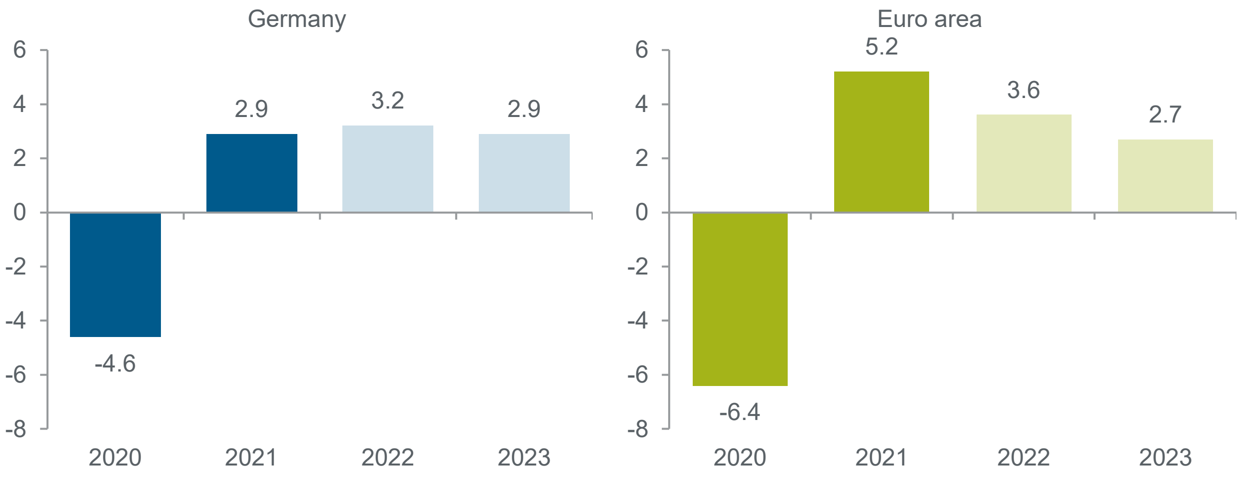
– KfW Research expects Germany's GDP to grow by 3.2% in 2022. GDP will surpass the pre-crisis level in the second quarter. With an annual growth of 2.9%, GDP will be similar to the pre-crisis trend towards the end of 2023, while quarterly growth rates will flatten.

– Because of the large statistical overhang from the previous year, the euro area will probably grow at a higher rate than Germany in 2022 (KfW's forecast: +3.6%). Next year it will be the other way around (+2.7%).

– Forecast risks include the escalation of the Russia-Ukraine conflict, entrenched high inflation, the pandemic and persistent supply chain problems.

Diagram 1: Growth of gross domestic product in Germany and the euro area

Variation on previous year in per cent, adjusted for prices



Sources: KfW Research, Destatis

Germany's GDP contracted sharply in autumn

Adjusted for price, seasonal and calendar variations, Germany's gross domestic product (GDP) shrank by 0.3% in the final quarter of 2021 on the previous quarter. This was mainly the result of the critical pandemic situation during the Delta wave with its high number of severe COVID-19 cases and high intensive care unit occupancy rates. Government-mandated measures such as restrictions on nightlife and far-reaching full vaccination or recovery requirements combined with people choosing to stay home for fear of infection weighed on private consumption. The 1.8% drop contributed significantly to the contraction of gross domestic product (GDP) (growth contribution: -0.9 percentage points). Contact-intensive industries, which form part of the 'trade, transport and hospitality' (-1.6%) and 'other services' sectors (-10%), suffered particularly sharp declines in value added. Hospitality was hit especially hard, with turnovers falling to just 58% of pre-crisis levels in December. Public service providers, education and healthcare, however, also suffered a noticeable 3.9% decline in value added. By contrast, value added in manufacturing picked up again (+1.9%) after contracting in the preceding quarters as a result of shortages of materials and inputs. The important automotive industry, in particular, which was also held up by severe bottlenecks from the semiconductor shortage since the beginning of 2021, was able to significantly expand production in autumn.

Despite the drop in the final quarter, however, the price-adjusted growth rate of +2.9% for 2021 as a whole turned out higher (including on a calendar-adjusted basis) than we had expected in our autumn forecast. This was due to significant upward revisions which the Federal Statistical Office made to the first-half growth rates. The rate now reported in the final quarter is also likely subject to revision given the high statistical uncertainty during the coronavirus crisis.

A subdued start to the year

The year also got off to a bad start due to the rapid spread of the Omicron variant, after the Delta wave subsided in December as expected. The first quarter has been divided with severe restrictions at first, followed by gradual relaxations from mid-February such as the nationwide lifting of the full vaccination and recovery requirement ('2G rule') for the retail sector. Overall, however, state-mandated restrictions on contact-intensive services remain on a similar level as in the preceding quarter, which includes October when restrictions were few. High levels of worker absence are also likely to somewhat hamper economic activity, as roughly 1% of the workforce was unavailable on average during the quarter as a result of reported infections alone.[i] The daily mobility index made available by Google for retail, hospitality and a range of recreational facilities, however, has already shown an upward trend since January and the activity indicators from the ifo economic survey and the Markit Composite PMI have all consistently indicated growth again since February. Overall, in the current quarter we expect a slight expansion of economic output at best, also with a view to developments in Ukraine (see risk section).

But growth will continue from spring

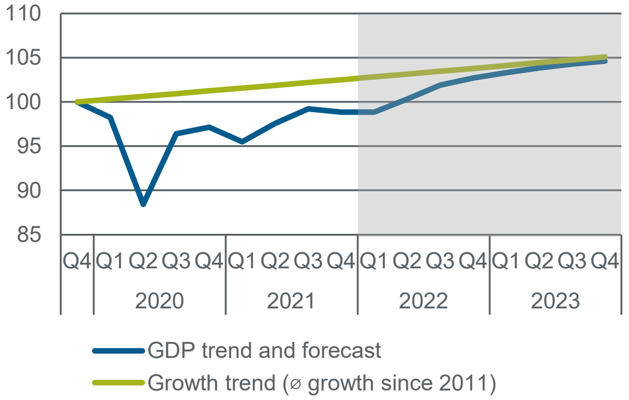
Vigorous catch-up growth will likely then follow in spring and summer. The relaxation of the vast majority of restrictions planned for the end of March will likely provide a boost to private consumption and the pandemic-plagued services industries, where the catching-up potential is still high. To be sure, very high energy prices are weighing on purchasing power. But their negative impetus on GDP is likely to wane in the course of the year as private households possess considerable excess savings from the times of lockdown which can mitigate losses in purchasing power.[ii] Much upside potential also exists in the manufacturing sector where order volumes climbed to new record high levels every month last year, as demand was high while production was hampered by material bottlenecks. Clearing the backlog of orders alone would now keep manufacturers busy for 7.7 months without any change to turnover. But growing investment appetite in particular means that demand for German industrial goods should also remain high in 2022. A management survey conducted by the European Commission in October and November, for example, revealed that a clear majority of Europe's industrial firms plan to expand investment activity in 2022.[iii] Furthermore, manufacturers' business expectations and incoming orders reported under the Markit Composite PMI to date are all pointing upwards.

According to an International Monetary Fund estimate, German GDP could have been a full 2.5% higher in 2021 without supply shocks in the manufacturing sector.[iv] And industrial growth will likely continue to be shaped by supply-side issues in 2022 as well. However, based on decreasing pandemic restrictions on global production and goods logistics, a shift from consumption back to services and the investments into new capacity already undertaken by producers of scarce inputs, material bottlenecks should improve to such an extent in the course of the year that manufacturing, too, will generate a noticeable growth surge. Some indicators such as the bottleneck-index of the ifo Institute and the delivery periods recorded under the Markit Composite PMI have already signalled a slight improvement in the supply situation since the turn of the year.[v] Surveys among businesses and experts also show that the majority expect supply chain problems to ease at least from the second half of 2022.[vi]

GDP forecast for Germany: +3.2% in 2022; +2.9% in 2023

All in all, German GDP will presumably grow at a stronger rate of +3.2% (including on a calendar-adjusted basis) in 2022 than in 2021 but less strongly than we had expected in our previous forecast of November (+4.4%). One reason for this is that the revisions in previous quarters also diminish the growth rate expected for the current year. The statistical overhang, that is, the momentum carried over from the year 2021, is lower today than predicted in November. Another reason is the muted start to the year resulting from the emergence of Omicron, high energy prices and probably a slightly slower easing of supply bottlenecks. The latter will probably not dissolve completely until the year 2023, so that part of the catch-up growth in industry will be further delayed. In combination with a considerable statistical overhang from the current year, the growth rate in 2023 is likely to be high as well at 2.9% (adjusted for calendar effects: 3.0%) but with significantly flattening quarterly growth rates. After gross domestic product exceeds the pre-crisis level – presumably in the second quarter of 2022 –, it is likely to converge on the pre-crisis growth trend at the end of 2023. A lasting return to the old growth trend is difficult to achieve, however, because the baby boomer generation's gradual retirement from the workforce will weigh on potential growth this decade.[vii]

Figure 2: GDP projection for Germany
Adjusted for price, seasonal and calendar variations; Q4 2019=100.



Source: Destatis, KfW Research

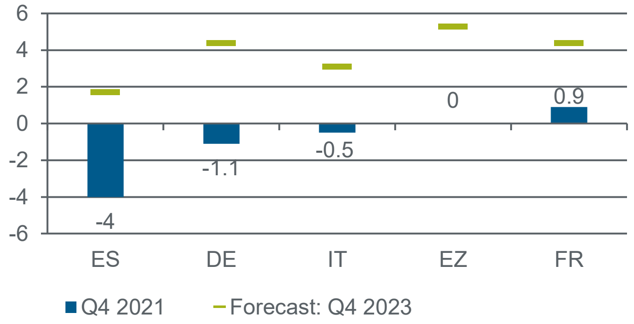
Euro area GDP has returned to pre-crisis level

While German GDP contracted in autumn, the output of the monetary union grew by 0.3% on the previous quarter. Real euro area GDP grew by 5.2% in 2021 as a whole. In particular, strong growth rates in the other three large euro countries bolstered the currency union. Quarterly growth was strongest in Spain +(2.0%) but still strong in France and Italy (+0.7% and +0.6%). The different pandemic situation explains most of the divergences in autumn. In some places the Delta wave had already surpassed its peak in summer and the burden on hospitals and the restrictions in place in the euro area were mostly lower than in Germany thanks to higher vaccination rates. Over the year as a whole, however, Germany's economy was hit hardest by supply bottlenecks because of the large share of manufacturing and the high weight of the particularly affected automotive industry. So although it had contracted less in the year 2020, German GDP in Q4 2021 was still 1.1% below the pre-crisis level of Q4 2019, while the economic output of the euro area is now right back on its pre-crisis level. The rest of the euro area probably got off to a bad start as well, however. In the face of exploding infection rates, restrictions were tightened moderately and demand for contact-intensive services declined at the turn of the year. Besides, particularly in France, very high infection rates make worker absences caused by infection a significant burden.

GDP forecast for the euro area: +3.6% in 2022 and +2.7% in 2023

Given the significantly higher growth at the end of the previous year, the euro area started the current year with a statistical overhang twice that of Germany. The euro area can therefore be expected to grow at a higher rate overall this year as well. We expect price-adjusted growth of 3.6% for 2022, followed by 2.7% in 2023. The quarterly profile will presumably be similar to that of Germany, although quarterly growth rates this year will likely turn out a bit lower due to a lower catching-up potential in the manufacturing sector. Among the large euro countries, Spain will again post the highest growth rate as tourism recovers. The reduction of public deficits will lead to negative fiscal impetus in the euro area, to be sure, but money from the EU Next Generation Recovery Fund should nonetheless secure robust public and private investment activity.

Figure 3: GDP in relation to pre-crisis level
Percentage deviation from Q4 2019



Source: Eurostat, KfW Research

Table: Price-adjusted GDP growth
Per cent year-over-year change

	DE	FR	IT	ES	EZ
2020	-4.6	-8.0	-9.0	-10.8	-6.6
2021	2.9	7.0	6.4	5.0	5.2
2022	3.2	3.2	3.4	5.1	3.6
2023	2.9	2.1	2.1	3.3	2.7

Source: Destatis, Eurostat, KfW Research

Upswing with risks

Like all forecasts, ours is also subject to a number of uncertainties that can lead to higher or lower growth rates. The particularly acute risks for Germany in the euro area include the consequences of Russia's attack on Ukraine, high inflation, developments in China and local pandemic developments:

– Our forecast assumes that Russia does not invade Ukraine or that any armed conflict is confined to the Donbass region. Open warfare, on the other hand, will primarily drive energy prices and inflation in the euro area even higher. This particularly affects Germany, which receives 58% of its natural gas supplies from Russia and meets around 14% of its final energy consumption with Russian natural gas alone[viii]. That will moderately affect economic output through loss of purchasing power as well as hamper energy-intensive production. In an extreme case scenario, energy may also have to be rationed, which would primarily affect manufacturing. According to a recent ECB estimate, a hypothetical 10% reduction in the supply of natural gas would reduce value added in the euro area and in Germany by around 0.7%.[ix] As a trading partner, however, Russia is of lesser importance to most euro countries and banks generally have a low direct exposure to Russia.

– As the majority of professional forecasters we, too, expect euro area inflation to settle in at around the target rate of 2% from 2023.[x] Accordingly, the ECB will normalise monetary policy only gradually up to a low neutral interest rate so that financing conditions in the euro area will tighten only moderately. The existing safety net of OMT, ESM and the fundamental readiness of the ECB to intervene are sufficient to rein in the spreads on government bonds. Should the ECB oversteer or the very high inflation become entrenched, however, for example through a wage-price spiral, that could choke off investment activity in the euro area and force a strict austerity policy in the highly indebted member states, even leading to a repeat of the sovereign debt crisis of the start of the last decade.

– The development of the pandemic in China poses a considerable risk to the global economy. At least until the party congress in November, the country is likely to hold onto its zero-COVID strategy with stringent restrictions. However, it is being hampered considerably by the increasing transmissibility of new variants such as Omicron and high incidence rates in the rest of the world. Our present forecast is predicated on the basic assumption that China will succeed at keeping infection rates very low thanks to its very extensive surveillance systems and that only sporadic disruptions to global supply chains will occur as a result of locally concentrated containment measures. Broad lockdowns in China, on the other hand, would indeed significantly exacerbate global supply bottlenecks. Combined with the problems of the Chinese real estate sector, that would also raise the threat of an economic crisis with global repercussions.

– Finally, the emergence of new variants and pandemic developments in Europe and Germany remain the main risks. In this respect, we assume a quasi-endemic situation in which relatively mild variants such as Omicron will continue to predominate so that in upcoming waves of infection, including next autumn and winter, it will be possible to avoid overwhelming the healthcare system by putting in place moderate restrictions such as mask mandates, partial testing or remote working requirements. But it is also possible that more virulent variants become dominant again or new waves of infection with the Delta variant emerge, against which previous Omicron infections provide hardly any protection. Policymakers have the power to minimise the risk of large numbers of severe cases, overwhelmed intensive care units and renewed setbacks for many businesses by preparing the next booster campaigns and introducing general vaccine mandates in due time, at least for the elderly population.

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[i] Cf. Scheuermeyer, P. (2022), Arbeitsausfälle durch Omikron summieren sich auf etwa 33 Mio. Tage *(Worker absences due to Omicron amount to approx. 33 million days – in German only)*, Economics in Brief No. 217, KfW Research.

[ii] Cf. Gunella et al. (2022) Natural gas dependence and risks to euro area activity, ECB Economic Bulletin, Issue 1/2022.

[iii] Cf. Box 1.3 in European Commission (2022). 'European Economic Forecast Winter 2022'. INSTITUTIONAL PAPER 169.

[iv] Cf. Celasun et al. (2022): Supply Bottlenecks: Where, Why, How Much, and What Next?, IMF WP/22/11.

v Cf. Materialmangel in der Industrie etwas entschärft (*Material shortages in industry have eased slightly* – our title translation, in German) | press release | ifo Institute.

[vi] Cf. Etwas weniger Materialmangel in der Industrie (*Slightly fewer material shortages in industry* – our title translation, in German only) | press release | ifo Institute. Lieferengpässe in Deutschland: Plötzlich steht die Produktion still (*Supply bottlenecks in Germany: Suddenly, production stands still* – our title translation, in German only) - iwd.de; Celasun et al. (2022): Supply Bottlenecks: Where, Why, How Much, and What Next?, IMF WP/22/11.

[vii] Cf. Müller, M. (2021). Deutschland muss produktiver werden, um die künftigen Herausforderungen zu meistern (*Germany must become more productive to meet the challenges of the future* – in German only), Focus on Economics No. 356, KfW Research.

[viii] Eurostat figures for the year 2020.

[ix] Cf. Gunella et al. (2022). 'Natural gas dependence and risks to euro area activity.' ECB Economic Bulletin, Issue 1/2022.

[x] Cf. The ECB Survey of Professional Forecasters – First quarter of 2022 (europa.eu)