Finanzgruppe
Deutscher Sparkassen-
und Giroverband

ECONOMIC UPDATE

Issue 1/2022

The war slows down the recovery

Berlin, 18th March 2022

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The war over Ukraine has upended many positions that were believed to be undubitable, both politically and under international law. The economic knock-on effects are also considerable and complex, both cyclically (in the short term) and structurally (on a long-term horizon). Macroeconomic growth momentum is clearly slowing down, and inflation is continuing to gain upside traction, at least temporarily.

A stagflation scenario is looming. However, thanks to the positive underlying trend, stripping out the effects of the war, Germany and even more so the euro area as a whole will probably stave off a further recession in 2022. The democratic countries of the West are paying a high price due to the Ukraine conflict, but a much less steep one than Russia, which is now almost completely isolated.

The shape of international value chains is shifting again as a result of the war. As a consequence, problems with supply bottlenecks and inflation are intensifying. This is especially true with regard to the energy supply and energy prices. There is now a still greater need for monetary-policy action to decelerate price increases. Although all central banks are acting cautiously in view of the turbulent situation and of more feeble growth dynamics, interest-rate hikes can now, paradoxically, be expected to come through even more quickly.

The war is slowing the recovery

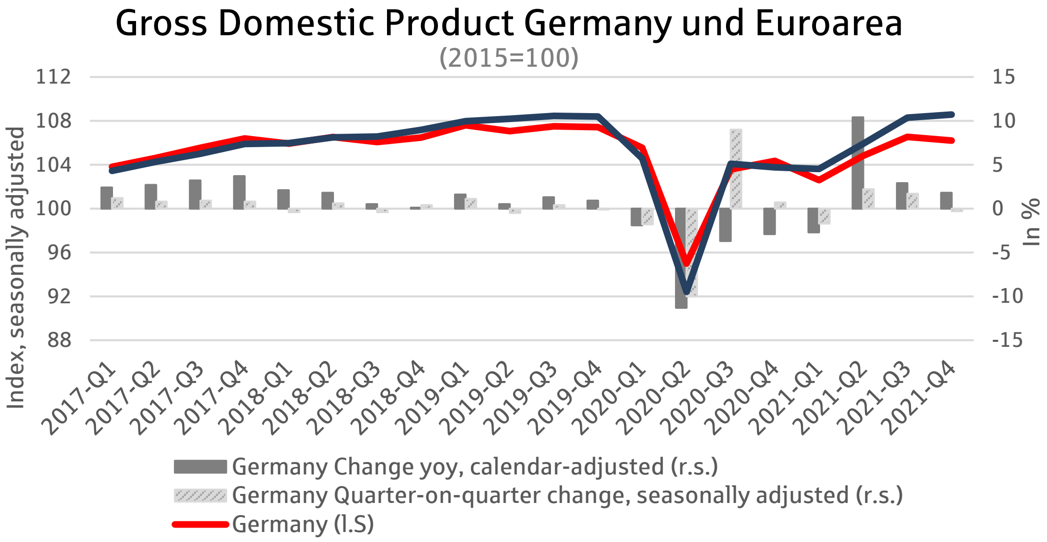
The war is displacing coronavirus as the main braking

The economic recovery phases proclaimed again and again over the course of the pandemic have had to be rescinded just as often and postponed time and time again. The potential for economic activity has been moving in lockstep with the dynamics of the infection trajectory, and this remains the case during the ongoing Omicron wave. For the subsequent period, most forecasts were, prior to Russia's incursion into Ukraine, assuming a strong recovery. But now the raw shock of the Russian invasion of its western neighbour has to be digested. Over and above the unfathomable human suffering and the incomprehensible violation of international law, the global economy has also been dealt a heavy blow. The economy, which in many countries was already crouching in the starting blocks for recovery, is once again being driven back into the foxhole.

The outbreak of war constitutes a shock for the world economy

With regard to the burdens stemming from the pandemic, it can now be positively noted that the economy, health-care systems, consumers and even public finances have increasingly learned to live with the situation. The losses in terms of value creation, employment and tax revenues have turned out to be less severe from wave to wave. Sentiment indicators underlined this in January and February, refusing to be browbeaten by the pandemic. It was curious that - for example in the case of the February ZEW survey for Germany - not only economic expectations remained favourable; the current-business-situation component actually improved as well, more or less exactly when the tally of Covid infections peaked. Another classic leading indicator, the ifo Business Climate Index, even gained ground through both the current-situation and the economic-expectations sub-indices. This was good news from the point of view of the assessment of the pandemic. However, the ifo Business Cimate gauge was already practically outdated on the very day of its publication (22 February) because of the escalation in the conflict over Ukraine to the point of open war. The survey results had, after all, been collected during the preceding weeks. The survey results in February had been collected even before that. However, the ZEW index published on March 15 then collapsed with a record drop of -93.6 points.

The start of the year was therefore already heavily burdened in several respects. On the GDP front, full figures for the first quarter of 2022 are not yet available, yet the monthly indicators already released for January reveal a mixed picture: production was still running at a low ebb, whereas new orders and retail sales, on the other hand, were on an auspicious path.

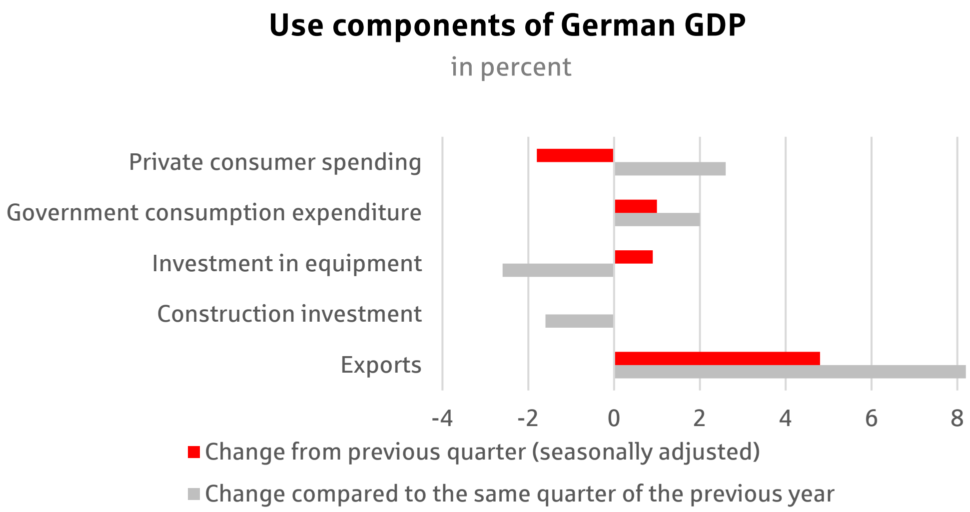


Source: Destatis, Eurostat

The final quarter of 2021 and the initial stages of 2022 were still heavily impacted by the pandemic

In the final quarter of 2021, real, seasonally-adjusted German GDP fell by 0.3 percent after adjustment for price, seasonal and calendar variations, according to the second official report from Destatis from the end of February. The first estimate from the end of January had even reported a decline of 0.7 percent. This interim upward revision provides some tailwind, resulting in a slightly higher statistical growth overhang for the start of 2022.

Now, during the first quarter of 2022, however, it is already clear that GDP will not be able to build on this now higher baseline. Rather, a stagnation scenario, or even a marginal growth contraction, needs to be braced for. That would spell two succesive quarters of negative GDP growth, fulfilling the precondition for a further "technical recession." However, such a recession has to be interpreted quite differently from a recessionary phase caused by purely economic factors, as the shock triggering it has obviously been an exogenous one, namely the "double whammy" of the Omicron wave and the war over Ukraine's future. Looking at 2022 as a whole, the economies in Germany and in most western industrialised countries are likely to manage to avoid slipping into recession. Growth rates will admittedly be depressed by the outbreak of war, but at the same time buoyed by the tailwind from the underlying recovery trend.



Source: Destatis

The hope was - and to a certain extent still is - that the long-awaited post-coronavirus recovery dynamic will finally start firing on all cylinders from spring onwards. The intermediate growth spurts witnessed whenever the economy has been reopened - as well as during the summers of 2020 and 2021, which were somewhat more relaxed in terms of the infection situation - buttress this hope. Then the trend pointed steeply upwards, at least in the short term - and such an uptrend will maybe now prove more permanent after the Omicron wave has ebbed away. Catch-up consumption and investment plans are settling down into their starting blocks everywhere. Savings and liquidity are still abundant. Further hopes are burgeoning thanks to the fact that investment activity and exports already shaped up decidedly favourably during the fourth quarter of 2021. It was mainly private consumption that was held back by the Delta wave rolling across the country, and then by the emerging Omicron wave. Nonetheless, it is still completely unclear how consumer sentiment will react to a new situation which has understandably also been psychologically affected by the fog of war.

Few new quantative projections are available so far:

	2022	**2023**
Deka 02.03.22	**1.7%**	**2.7%**
IfW Kiel 17.03.22	**2.1%**	**3.5%**

The forecasts for 2022 full-year growth, which were usually ranging between 3 percent and 4 percent in Germany's case before the outbreak of hostilities, are now being corrected downwards in all quarters. This adjustment process, like the breaking news about the course of the war itself, is still very volatile. The most recent quantitative forecasts of GDP growth have been hovering in the ont to two percent range. Accordingly, we are also expecting that the 3.7% macroeconomic growth rate foreseen for the euro area in 2022 in the latest ECB staff projections on 10 March will have to be adjusted significantly downwards again, in June 2022 at the latest. The medium-term growth outlook for the various sectors of the economy has also been clearly crimped.

The impact of the war which has broke out in Ukraine

The situation in Eastern Europe and the progressive build-up of Russian troops has been spawning uncertainty for quite some time. However, the fact that all inhibitions have now been abandoned on the Russian side and that open war has broken out entails a complete paradigm shift. The escalation in question constitutes a shock for diplomacy, for world politics and its security architecture but also for financial and goods markets. It is not yet possible to estimate how severe the resulting slump in trade and production will prove to be.

The breach of the taboo on war is welding the West together...

... but is simultaneously undermining the international division of labour

The effects of this crisis are not linear. The new dimension of the current military confrontation is dealing a considerable blow to international cooperation. Although the Western countries are now standing closer shoulder-to-shoulder again within their alliances, the division of labour with Russia has been disrupted almost entirely. Protectionism and security considerations are gaining ground. The military altercation which is raging is therefore further aggravating the already ongoing process of de-globalisation, which is destined to remain a structural effect.

Selected sanctions imposed against Russia

Military goods	Dual-use goods	Technology goods
Aerospace goods and services	Maritime goods	Partial SWIFT exclusion
Exclusion from the European financial market	Visa restrictions	EU airspace shut to Russian aircraft
Oil extraction goods and services	Exclusion of Russian companies from the EU capital market	Revocation of broadcasting licences of Russian broadcasters

SWIFT and energy deliveries are the most sensitive domains

Of direct relevance for the immediate economic effects are the sanctions imposed on Russia and the possible supply boycotts. The corresponding carousel of measures was set in motion as soon as Russia invaded its neighbour, and was beefed up considerably only a few days later. In addition to targeted measures against certain groups of people, large swathes of the Russian banking sector, including the Russian Central Bank itself, have been sanctioned by the USA and the EU. In the second wave of sanctions, Russia was also largely excluded from the SWIFT system. This is, admittedly, a double-edged sword, as it could mean that Western nations have to deal with debts that are technically no longer serviceable. Potentially, payment transactions involving the energy sector could likewise be affected. This may accelerate the shut-off of gas supplies to Europe which is threatening in any case as a possible Russian countermeasure.

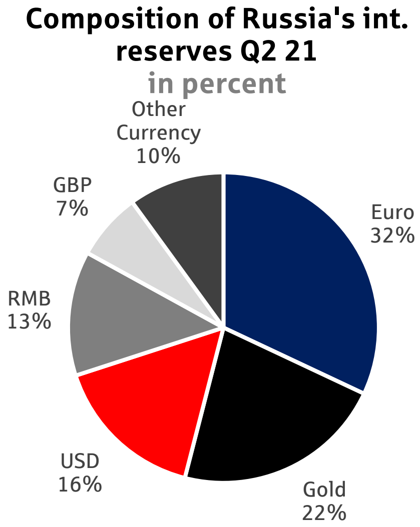
But that is the price to be paid in defence of freedom. The aggressive actions of the Russian leadership do not allow for any other reaction. It is very much to be welcomed how united the response of almost the entire world has been. With Russia largely isolated in the spheres of diplomacy, economics and almost all branches of civil society, the impact and the signal to the population and to those circles in Russia most likely to stop Putin is the most forceful.

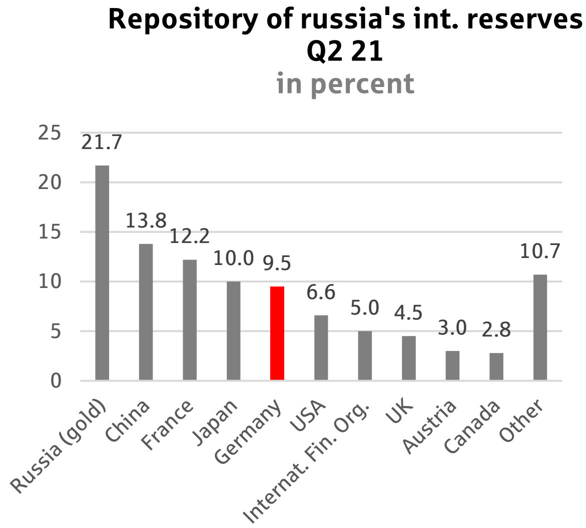
The West's unflinching and unified course enjoys broad support, from the business community as well. Many companies have already declared that they intend to discontinue their economic relations with Russia completely, even beyond the concrete sanction measures. The Savings Banks Finance Group likewise supports this approach: we will help customers of ours who are making corresponding plans, or else who are affected by the economic measures, constructively and in a spirit of solidarity.

The corporate sector is resolutely supporting the sanction measures

Russia itself is going to be hit hardest - especially in the long term

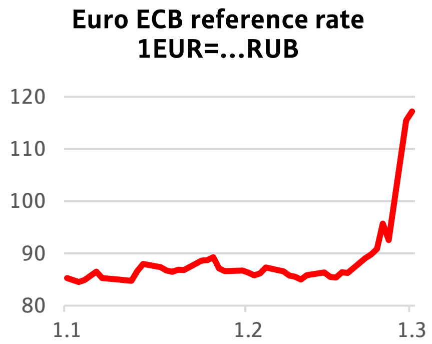
It is true that Russia will show a certain short-term resilience to these payment and financing severances. Public debt is manageable at around 18 percent of GDP. As a country running current-account surpluses (over 5 percent of GDP in 2021), it does not need to finance an ongoing deficit with the rest of the world. On the contrary, Russia has built up a positive net external position over the past few years, and can point to both foreign assets and foreign-exchange reserves.





Source: CBR, Deka Bank

However, the country's foreign-exchange reserves are now frozen to a large extent. The Russian central bank, which is itself directly subject to sanctions, can hardly mobilise the available reserves to defend the exchange rate. This is another reason why Russia's monetary authorities have had, as an alternative attempted remedy, to resort to a sharp increase in the key interest rate from 9.5 to 20 percent. Despite this draconic tightening measure, inflation in Russia is still fated to accelerate considerably, simply because of the curb imposed on imports and due to the sharp depreciation of the local currency. The Russian inflation rate will soon easily overtake the sharply hiked key interest rate.



Source: ECB
The ECB suspends the publication of the euro reference rate against the rouble with effect from 2 March 2022 until further notice!

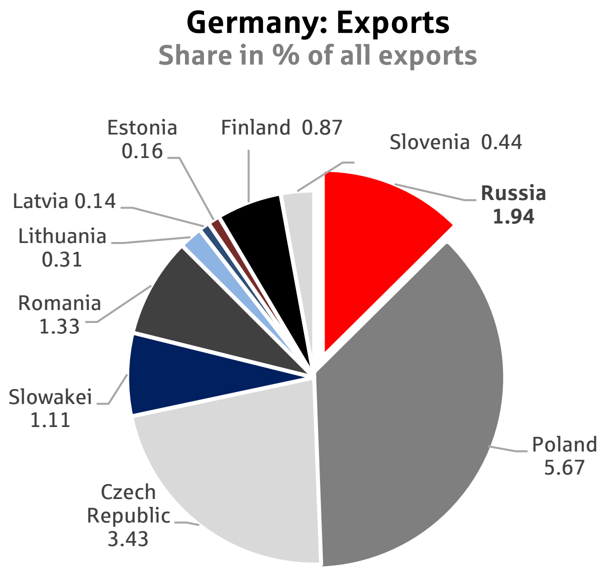
The Russian rouble has lost considerable traction on the foreign-exchange markets, by around 40 percent against both the US dollar and the euro during the first two weeks following the onset of the invasion. The share prices of Russian companies have fallen off a steep cliff, with the Russian stock exchange having now suspended trading for three weeks.

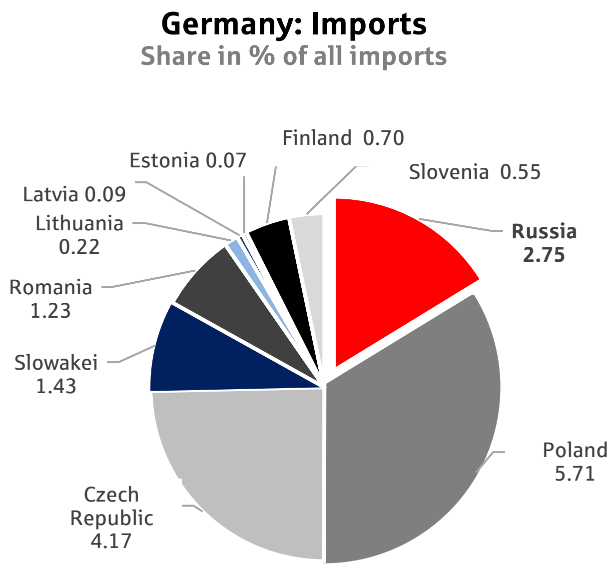
Russia also punished on financial markets markets

Russia is destined to be severely affected by the isolation caused by the aggression of its leadership, especially in the long term. The country's development is going to be seriously damaged by the lack of technology, exchange and of a productivity-enhancing division of labour. Even a more pronounced pivot towards China can only gradually change such a state of affairs. The Russian economy had already been falling behind for years. The one-sided focus on the raw-materials sector and the absence of an open society have inhibited the modernisation of industry and the services sector alike.

Trade is of greater significance in qualitative than quantitative terms

By contrast, trade with Russia is rather insignificant in terms of magnitude from the perspective of Western countries. The shutdown in relations that has been initiated will hurt the West too, but on a much smaller scale than it will Russia itself. The direct share of Germany foreign trade relating to Russia is comparatively slight: only 1.9 percent of German exports were shipped to the Russian Federation at last count (as of 2021). This corresponds to just 0.7 percent of Germany's GDP. Of course, the loss of turnover is not evenly distributed, with certain sectors which have a focus on business with Russia being disproportionately affected.



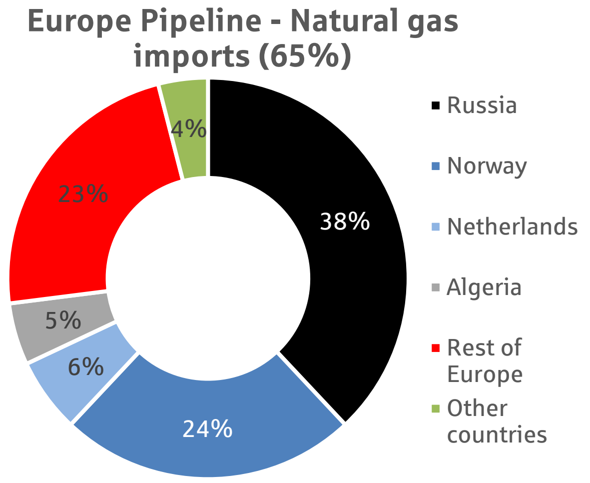


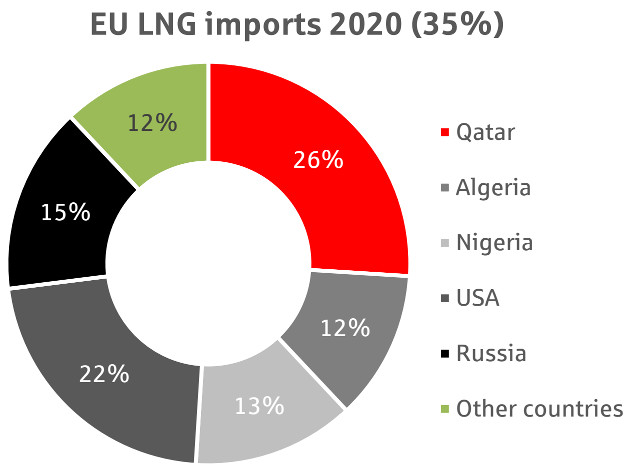
Source: Destatis

The bigger problem is to be found on the import side, but not on account of the magnitude involved. In terms of pure volume, this would also be bearable, although imports in bilateral trade are somewhat higher than exports. 2.8 percent of German imports come from Russia, which corresponds to 0.9 percent of German GDP. Among these shipments, however, are key strategic goods, various raw materials, especially natural gas, as is well known. Even before Nord Stream2 went into operation, more than half of Germany's consumption of this commodity came from Russian sources. Strategically, it is important to overcome these dependencies, in the long term, ideally, by switching to renewable sources, temporarily as a bridge, if necessary, by using LNG (liquefied natural gas).

Dependence on Russian energetic raw materials must be reduced

In the current cycle, energy supply, especially for gas, has already been tight throughout the winter, which is being made manifest by the corresponding trend in prices. Now, however, it is not just about prices but, on a worst-case scenario, about sheer physical availability.





Source: Bloomberg, Refinitiv, BayernLB Research

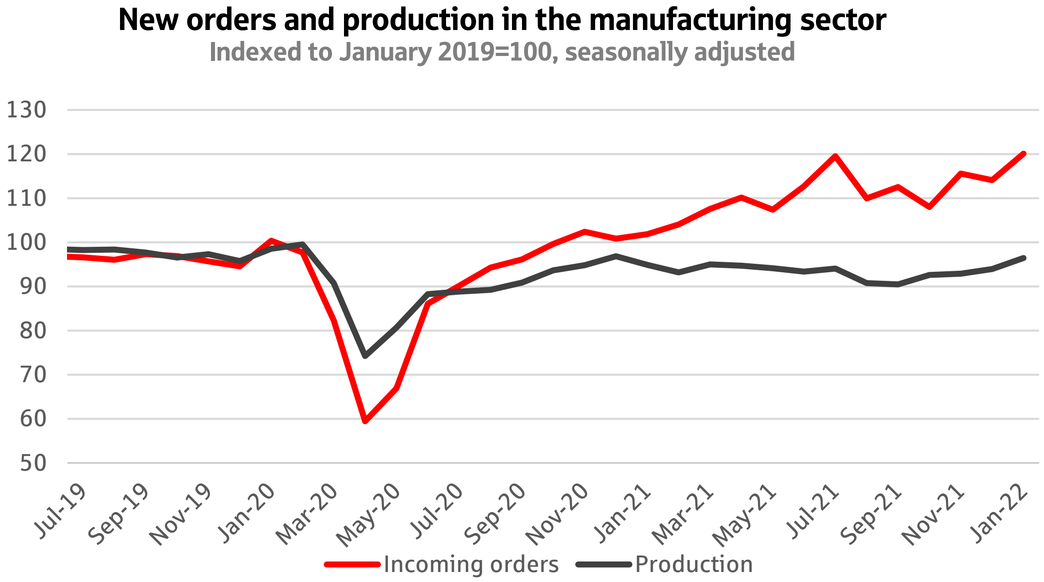
Supply bottlenecks remain a limiting factor

Bottlenecks remain an issue independent of the war ravaging Ukraine

This is a constellation that we already know from many areas in 2021, not due to war, but in the form of capacity bottlenecks on the transportion and intermediate-input fronts. If key components are missing, then an exceedingly disproportionate proportion of value creation may be lost. Figuratively speaking: an entire car cannot be produced because of a missing chip.

The non-war bottlenecks were just beginning to ease a little, partly because new capacities were being created in the global economy to underpin the expected post-coronavirus upswing on the supply side. However, even without the war, there were still some looming bottlenecks. If a Covid-19 wave were indeed to wash across China, which has been successfully shielded for more than a year and a half, the government in Beijing could react with harsh measures such as port closures, which would, in turn, generate fresh bottlenecks.

The discrepancy between incoming orders and actually processed production has already been pointed up and analysed several times in this publication series since last summer. This disconnect can still be seen in the data sets that are now available up to and including January 2022.



Source: Destatis

That said, the principal factor influencing the issue of supply bottlenecks is now clearly the war. The abrupt disruption in the division of labour is opening up painful gaps. Some of these are already known and have been named; others have not yet emerged, and may do so via second-round and third-round effects through production in other countries.

The growth-momentum ranking had changed even before the outbreak of war

Other European countries have made a better showing recently

The inveterate, and now newly emerging, bottlenecks are a disproportionate burden for Germany compared to other countries, not only because of the Federal Republic‘s geographical proximity to the conflict zone. This is a function of the disproportionate weight of industrial production in the total value added in Germany’s 16 federal states. Even before war broke out, a divergent field had already opened up across Europe with respect to the incipient recovery. The euro area as a whole was already able to report slightly positive growth of 0.3 percent in the final quarter of 2022. Were Germany to be left out, this rate of change would have been about twice as high. While Germany's GDP level is still below the pre-crisis level in price-adjusted terms, the euro area has meanwhile regained its pre-crisis aggregate economic output level. Quite apart from a global comparison involving much more dynamic economic areas such as the USA, which have long been reaching higher and are now well above the German level, even moving back up towards their extrapolated pre-crisis potential-growth path.

Within Europe, it is above all France and Italy among the large countries that have recently attracted positive attention.

Gross domestic product, price, seasonally and calendar adjusted 4th quarter 2021, change in %:

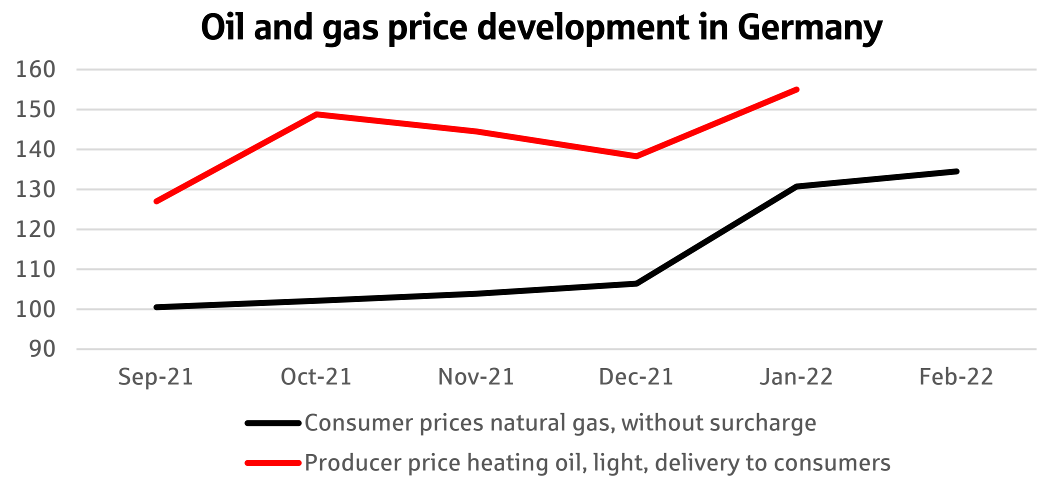
Real GDP compared to the…	Euroarea	Germany	France	Italy
Previous quarter	0.3%	-0.3%	0.7%	0.6%
Previous year's quarter	4.6%	1.8%	5.4%	6.4%
Pre-crisis quarter	0.0%	-1.1%	0.9%	-0.5%

* Q4 2019

The pre-crisis level is now further away in Germany than in other European countries. Catching up will not be easier now during the war and due to the isolation of Russia, since German manufacturing is more closely interlocked with Eastern European industry than, for example, the industrial sectors of France or Italy.

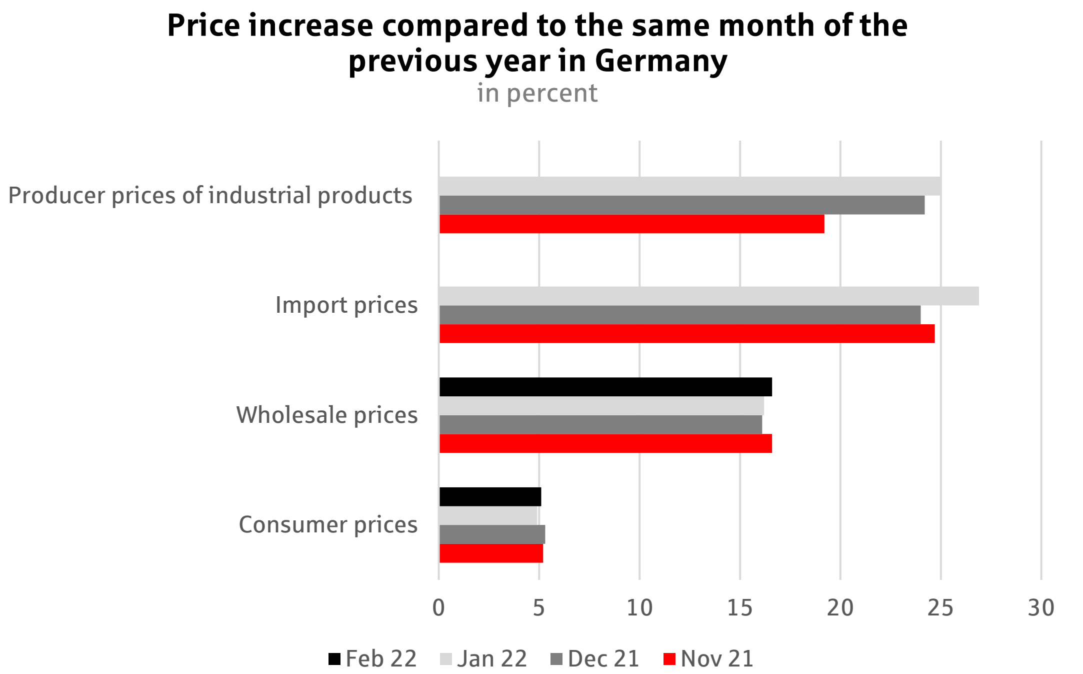
Already high inflation is now being additionally fuelled by war

Inflation rates, which have already been high for three quarters of a year, are now poised to remain at their elevated levels for longer and even to reach new heights. The drivers on this score are primarily energy prices.



Source: Destatis

In addition, the overall supply and demand conditions continue to compound the ongoing price pressure. In any case, further pressure has been in the "pipeline" for months now, if it is possible to use such a metaphor in this context these days.



Source: Destatis

Inflation expectations are becoming entrenched at higher levels, and second-round effects accordingly loom

In view of the prospect of persistently high inflation, demands for inflation compensation are also being voiced more frequently in the collective-bargaining process (cf. the concept of the wage-price spiral). The extent to which demands for "agreements above the inflation rate" refer to the current inflation rate, expected rates over a medium-term period or the ECB's inflation target remains open in many cases.

The European Central Bank must be careful to ensure that its inflation target remains credible if it continues to be exceeded. The need for monetary-policy action, which already existed before Russia’s incursion into Ukraine, has increased even more as a result of the war and of the accompanying further spike in inflationary pressure. It is understandable that central banks are acting cautiously in view of the current tense situation on the financial markets. Measured against this benchmark, the ECB acted quite decisively at its most recent Governing Council meeting on 10 March 2022. After all, Team Lagarde did resolve to accelerate the pace of its bond-purchase taper. This has opened up leeway for the ECB to implement initial key interest rate hikes over the second half of 2022.

The capital markets have been on a veritable rollercoaster ride during the first three weeks of the war. First, a "flight to safety" once again depressed government-bond yields, with 10-year Bunds returning to negative territory after February's "liftoff" beyond the zero bound. However, this trend reversed once again in the week of the ECB Governing Council's decision.

Additional fiscal challenges

Such an occurrence can also be explained by the altered fiscal-policy tack: the EUR 100 billion special fund for armaments expenditure on the Bundeswehr, launched very swiftly by Germany's politicians, has once again sharply raised the country's refinancing requirements. In addition, further fiscal challenges are now facing Germany and other European countries, such as the considerable expenses for the care and accommodation of war refugees.

The need for monetary-policy action has become even more acute

The euro has lost a little altitude against the US dollar recently. On the one hand, this certainly reflects Europe's greater vulnerability to the outbreak of war, e.g. through energy dependencies, but on the other hand it also mirrors the widening transatlantic interest-rate differential. In turn, this bout of euro depreciation is contributing to the surge in inflation.

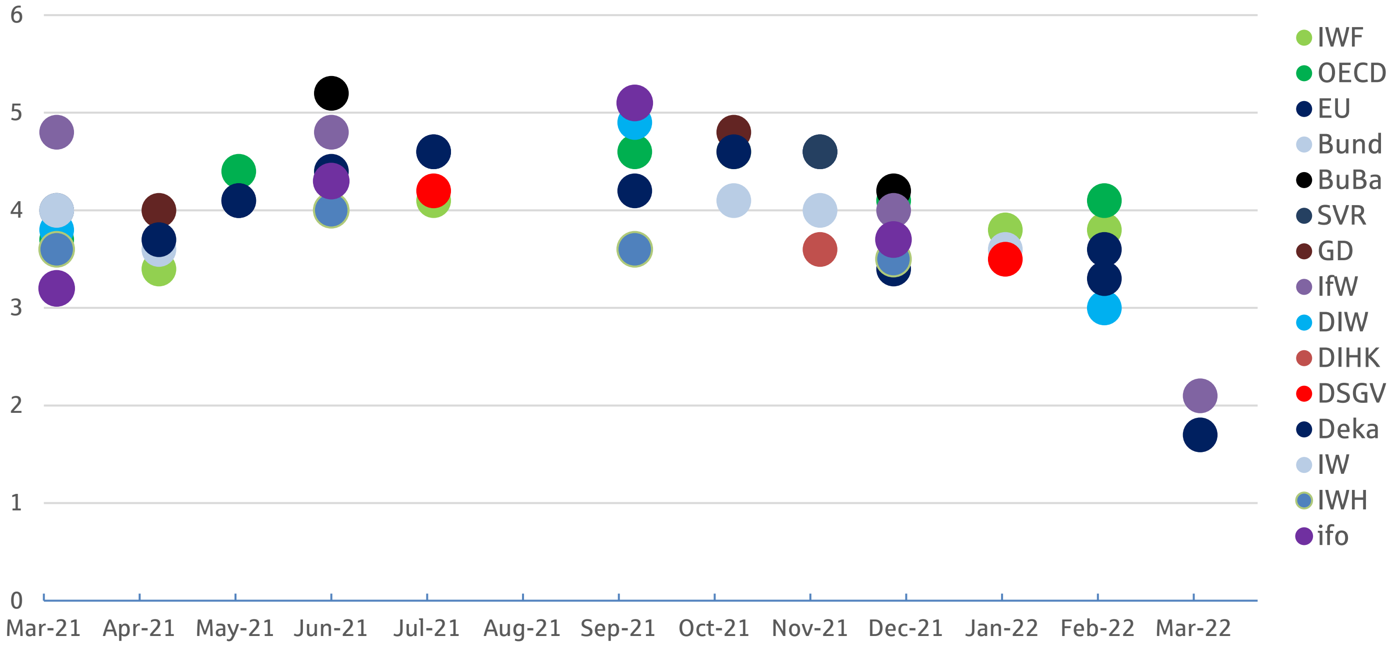
The extremely low interest rates prevailing at present - in real terms (nominal interest rate minus inflation rate), these have even plummeted further into negative territory due to the further increase in inflation - are no longer appropriate to the situation. Therefore, the ECB should stick to the exit path despite the depredations of war - that it is doing so became clear in essence with the plan to reduce bond purchases in the period to June 2022. It would also be important to monitor whether the currently negative deposit facility rate - which is functioning as the ECB's main policy rate at the moment - could not be reduced to zero in a more rapid manner.

A. Growth of world economic regions, change on previous year

	2020	2021*	2022*	2023*
World trade volume	-8.2%	9.3%	6.0%	4.9%
GDP - World	-3.1%	5.9%	4.4%	3.8%
USA	-3.4%	5.6%	4.0%	2.6%
Japan	-4.5%	1.6%	3.3%	1.8%
China	2.3%	8.1%	4.8%	5.2%
Euro area	-6.4%	5.2%	3.9%	2.5%
Germany	-4.6%	2.9%	3.8%	2.5%

* International Monetary Fund January 2022 projections.

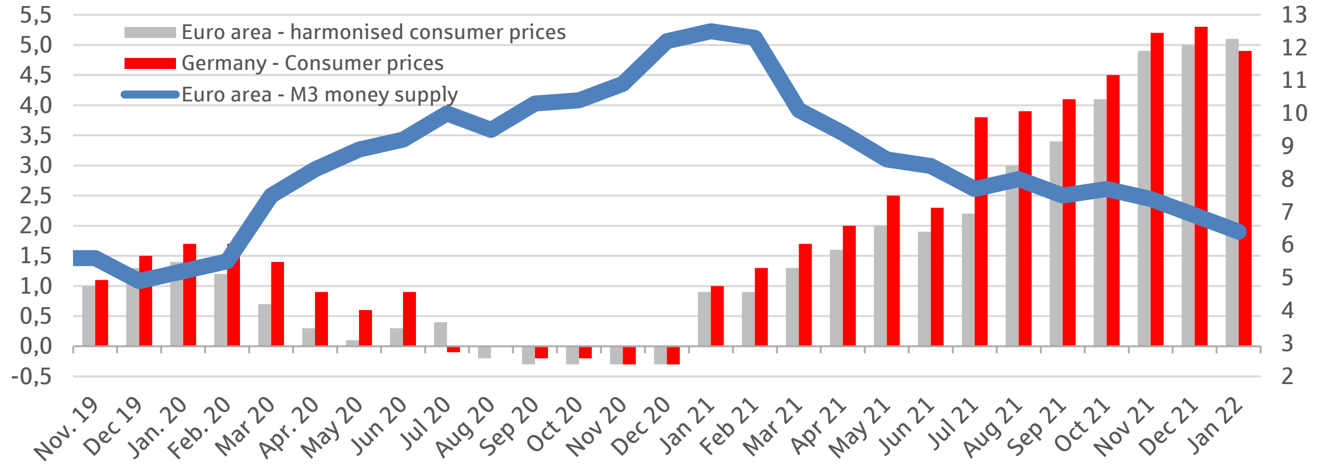
B. Economic growth forecasts for Germany for 2022, in %



C. GDP in the euro area and in Germany

	Year 2021 real vs. previous year	Q I - 2021	Q II - 2021	Q III - 2021	Q IV-2021
		Real change from the same quarter of the previous year and seasonally adjusted real change from the previous quarter			
Euroarea GDP	+5.3%	-0.9% -0.1%	+14.6% +2.2%	+4.0% +2.3%	+4.6% +0.3%
Germany GDP	+2.9%	-2.9% -1.7%	+10.4% +2.2%	+2.9% +1.7%	+1.8% -0.3%
Private consumption	+0.1%	-9.2% -5.2%	+6.5% +3.7%	+1.4% +6.0%	+2.6% -1.8%
Gross fixed capital formation	+1.5%	-1.0% -0.5 %	+8.7% +1.3%	+0.1% -2.9%	-1.5% +0.5%
Exports	+9.9%	-0.1% +1.9%	+27.6% +1.1%	+7.5% +0.0%	+8.2% +4.8%
		Level, not rate of change; quarterly figures seasonally adjusted			
Savings rate	15.0%	19.0%	16.8%	11.9%	12.5%

D. Consumer prices (left scale) and money supply M3 (right scale), annual rates of change in %.



E. Monthly economic indicators Germany

	October	November	December	January	February
Prices (national definition)	Change compared to the same month of the previous year				
Consumer prices	4.5%	5.2%	5.3%	4.9%	5.1%
- Excluding food and energy (core inflation)	2.9%	3.3%	3.7%	2.9%	-
Producer price of industrial products	18.4%	19.2%	24.2%	25.0%	-
Import prices	21.7%	24.7%	24.0%	26.9%	-
Sentiment indicators					
ifo Business Climate Index	97.9	96.6	94.8	96.0	98.9
ZEW Economic Sentiment	22.3	31.7	29.9	51.7	54.3
Incoming orders	Change compared to the same month of the previous year				
Manufacturing industry	-2.8%	3.1%	8.0%	10.5%	-
from within Germany	-1.9%	0.1%	14.1%	8.0%	-
from abroad	-3.3%	5.2%	4.3%	12.0%	-
Capital goods producers	-4.8%	3.5%	9.7%	15.8%	-
Production	Working day adjusted change compared to the same month of the previous year				
Total manufacturing industry	-1.2%	-2.2%	-2.7%	1.8%	-
of which construction	-0.2%	-2.1%	-10.9%	12.3%	-
thereof industry	-1.6%	-2.4%	-1.0%	0.2%	-
Foreign trade	Change compared to the same month of the previous year				
Export	8.2%	12.3%	15.5%	-	-
Import	17.4%	19.9%	28.1%	-	-
Labour market	Unemployment rate / change in the jobless total compared to the same month of the previous year (in 1.000s)				
Unemployment rate	5.1%	5.4%	5.3%	5.4%	5.3%
Unemployed	-383	-382	-378	-439	-
Employed persons (with place of work in Germany)	+345	+452	+506	+636	-
Employees subject to social security contributions	504	552	603	-	-

F. Commodity, foreign exchange and financial markets

	November	December	January	February	March(15th)
Brent **oil price** in US $	81.54	74.17	86.51	97.13	106.64(17th)
Exchange rates					
US- Dollar / EUR	1.1414	1.1304	1.1314	1.1342	1.0991
Japanese Yen / EUR	130.12	128.80	130.10	130.66	129.67
Stock markets					
German DAX share index. End of month	15,100	15,885	15,471	14,461	13,917
Change on the same month oft he previous year	13.61%	13.64%	13.71%	4.67%	-
Money and capital market interest rates					
Call money (€STR)	-0.573%	-0.577%	-0.578%	-0.577%	-0.577% (14th)
1-month money (EURIBOR)	-0.57%	-0.60%	-0.57%	-0.55%	-0.56% (14th)
3-month money (EURIBOR)	-0.57%	-0.58%	-0.56%	-0.53%	-0.50% (14th)
Current yield of German government bonds	-0.40%	-0.24%	-0.08%	0.15%	0.30%
Interest rates of credit institutions, in new business					
Daily deposits of private households in D	-0.01%	-0.01%	-0.01	-	-
for comparison across the euro area	0.01%	0.01%	0.01	-	-
Deposits from households up to 1 year in D	0.09%	-0.07%	0.11	-	-
for comparison across the euro area	0.17%	0.16%	0.19	-	-
Corporate loans up to €1m over 5y in D	1.44%	1.45%	1.53	-	-
For comparison across the euro area	1.47%	1.40%	1.46	-	-

Imprint

Publisher

German Savings Banks and Giro Association e.V.

Charlottenstrasse 47
10117 Berlin
Tel: 030 20225-5303
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www.dsgv.de

Editorial deadline for this issue
18th March 2022

Design
Franz Metz, Berlin
Picture credits
Titelseite: Plainpicture/Westend61

ISSN
2509-3835

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