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Stagflation is about the best we can hope for at the moment

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Downside risks are currently dominating proceedings on the world markets. The late phase of the pandemic, the war, energy shortages, supply-side bottlenecks, de-globalisation tendencies and fresh geopolitical crises are interacting ominously. Meanwhile, inflation continues to vault to new record levels.

It was against such a backdrop that the Chief Economists of the Savings Banks Finance Group drew up their new "Joint Forecast" in summer 2022. Under their main scenario, they forecast stagnation for Germany in the second half of 2022 and for 2023. With gas shortages worsening, there is a threat of recession. Only the labour market continues to prove very robust during this concatenation of crises: the downside here is that the shortage of (skilled) labour is destined to persist.

Wage pressures further increase the risk of rampant inflation becoming entrenched. Shielding citizens from inflation's effects will only be possible in a few cases of hardship; by contrast, "relief" measures that are too broad-brush would risk exacerbating inflationary dynamics. Interventions ignoring price signals invariably reduce the sensible thrift that needs to be practised with scarce resources. Germany will hardly find it possible to maintain "normal" consumption levels. With the Terms of Trade deteriorating, the country is inevitably going to become poorer.

Stagflation is about the best we can hope for at the moment

Various acute and permanent problem constellations are continuing to interact

Ever more new crises and flashpoints are continuing to compound the already complicated stress situation we are facing. The coronavirus has not yet been overcome, and yet new infectious diseases are already spreading. To add to the supply bottlenecks and the war in Eastern Europe, other geostrategic hot spots have emerged in recent weeks, whether in the Middle East or in the Far East. The tensions over the Taiwan Strait, if they were eventually to flare up into actual war, would have the potential to fatally undermine world trade to a much more serious extent than the wars already taking place. This is true not only because of Taiwan's prominent role in the production of semiconductor chips, whose shortage has, as is well known, been crimping industrial production in many parts of the world for more than a year now. It is more generally a matter of China's close degree of interdependence with the entire global economy, which could accordingly experience a considerable shock. In addition, the domestic economic situation in the People's Republic of China no longer appears to be as robust and fast-growing as has been the case over the past two decades. Tensions in the Chinese financial and construction sectors cannot be ruled out either.

Taiwan is a further unresolved geopolitical conflict....

...a flare-up of outright war with China would hit world trade even more severely than the war raging in Ukraine

At the same time, the major long-term issue deciding on mankind's destiny, climate change, has revealed in many places this summer just what deleterious effects are already at work. Heat waves, glacier melt and drought have reached record levels. Forest fires have been ravaging large swathes of Europe and of other global regions. Water levels in the River Rhine were disturbingly low this summer, making it largely unusable as an inland waterway. This is yet another bottleneck factor in the multifaceted narrative involving supply snarls and material shortages. The gas tap determining pipeline flows from Russia has been turned off completely first for some other countries, but now also for Germany. The technical reasons (pipeline maintenance, delayed return of a turbine) alleged by the Russian side hardly conceal the open power game being waged about arms deliveries, sanctions and counter-sanctions. Germany, like Europe in general, would do well to prepare for a complete supply breakdown and corresponding bottlenecks during the coming winter. Gas-saving and rationing plans are necessary, have already been implemented in some cases, and are now being stepped up further.

Drought and forest fires move to centre stage as harbingers of climate change

A gas shortage in the coming winter is becoming an increasingly concrete possibility

Inflation remains a predominant theme for many currency areas in any case. In the event of further military escalations and further disruption of trade flows, the inflation monster would be given fresh fodder. But even in the absence of new shocks, it will be difficult at all events to effectively limit the price momentum that has broken out of its box on the back of excessively abundant money-supply growth over the past ten years. A monetary-policy braking process countering the effect of the unconventional instruments deployed during a long accommodative phase marked by quantitative easing, negative interest rates and (still ongoing) excess liquidity is a completely new exercise on the historical highway. Implementing monetary-policy normalisation with as little loss

Global Consumer Prices
Twelve-month rates
July 2022

USA (CPI)	8.5%
UK (CPI)	10.1%
Euro area(HICP)	9,1%
Germany (HICP)	8.8%
Germany (nat. CPI)	7.9%

Source: Destatis, Eurostat, BLS, ONS

of real economic growth as possible is anything but easy, especially in the current complex situation. A clear priority in favour of fighting inflation is urgently needed nevertheless.

Uncertainty is also a function of the methodology used in statistical reporting

In view of the complex knot of multiple crises and burdens delineated above, it is difficult to remain confident. "Uncertainty" is the big buzzword doing the rounds. And such uncertainty applies not only to the various strands of development themselves, but currently also to the process of measuring and recording of economic activity. Not only is the future uncertain - so too, to some extent, is the present and the recent past. So where are we actually standing?

Official data is subject to frequent and extensive revisions

Shifts in GDP growth levels have been very volatile in the recent past; but statistical reporting is also more susceptible to disruption in such a situation. This is demonstrated by the frequent - and decidedly sizeable - revisions of the official data. From a methodological point of view, the initially published "flash" estimates do not add up to a complete record, but are always only based on partial observations. They therefore draw on corresponding "rough and ready" projections. This works well enough in normal times; but in the event of hefty fluctuations and in special situations, the extrapolation factors are not always stable and can alter fundamentally. Just when things get particularly exciting, you are left fumbling in the dark.

"Flash" estimate versus final data - an unavoidable trade-off

As more and more information becomes available, the "actual" figures have to be adjusted several times ex post. The picture of the situation sometimes changes not only gradualistically, but also qualitatively, in the process. This is not meant to be a criticism of statistical practice: a trade-off between timely publication of initial results and the robustness of such data is obvious and unavoidable. A provisional "best guess" by professional official statistics is better than no guidance at all. But especially in such volatile times as we are navigating at present, it is necessary to be aware that even official data are not set in stone, but rather represent only preliminary "guesstimates" based on what has been found out so far. Given the large number of revision rounds, over a timespan of years following the period surveyed, the process now more closely resembles a long bout of "feeling one's way" towards the objective situation than a one-off "grand pronouncement."

Ultimately, it is hardly surprising that readjustments are more pronounced when swings in GDP themselves are larger than usual. In this context, it is noteworthy that GDP swings of well over three percent on a full-year basis, which in the past would have been classified as a "once-in-a-century event," have recently tended to occur only a decade apart (cf. the financial crisis 2008/2009 and the coronavirus crisis 2020ff).

Against this backdrop, it is worth taking a closer look at the latest round of revisions by the Federal Statistical Office, published at the end of July and then again at the end of August 2022. The national accounts for

Real German GDP

Before and after the revision from July/August 2022

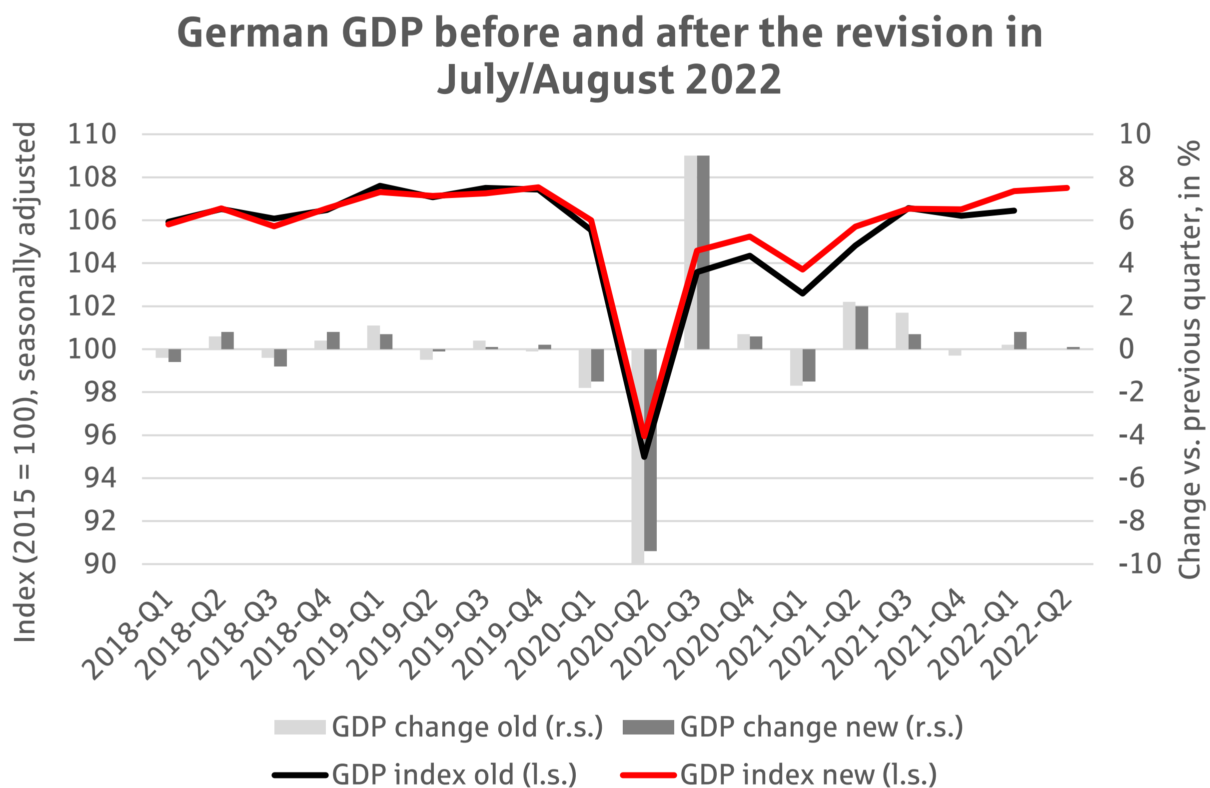
Year	Old	New
2018	+1.1%	+1.0%
2019	+1.1%	+1.1%
2020	-4.6%	-3.7%
2021	+2.9%	+2.6%

Source: Destatis

Germany were reopened again, going back to 2018. Post-adjustment, the real GDP slump in 2020 works out at -3.7 percent, not quite as deep a plunge as previously thought (-4.6 percent; or, adjusted for calendar-day variations, -4.1 percent instead of -4.9 percent).

The initial estimates before earlier revision rounds even overshot the minus-five-percent mark. After the latest methodological tweak, on the other hand, the 2021 recovery - a positive growth rate of 2.6 percent - does not look as strong as initially forecast before the latest revision.

Further details can be gauged from the quarterly figures, both from the rates of change in the respective quarter and from the trajectory of the GDP level along the indexed line, in which the various fluctuations are cumulated.



Source: Destatis

The most recent aggregate-economic-output level looks somewhat higher in the revised figures - i.e. at the right-hand end of the red line. Germany's real GDP has now at least returned to the pre-crisis level from the end of 2019. True, this is only a small consolation, as we have still missed out on the two-and-a-half years of trend growth over the coronavirus cycle which we would otherwise have been able to assume. Germany's performance is not particularly sterling on an international comparison either, as macroeconomic growth in most industrialised countries has once again been exceeding its pre-crisis level for some time now. Nonetheless, the new situation is still better than prior to the correction, of course, when it still looked as though the pre-crisis level had not even been matched. The question, however, is whether this level will be maintained, or whether a renewed recession in the event of a

German GDP too has - finally - inched its way back up to the pre-crisis level

winter possibly overshadowed by gas shortages will even push the volume of aggregate economic output back down to below the 2019 level.

We have witnessed a rapid V-shaped recovery, but a negative output gap remains a long-term legacy

The "crater" caused by the impact of Covid-19, particularly during the first wave of infections over the spring of 2020, is no longer looking quite as deep as first thought, on the basis of the statistical findings unearthed in the interim. The quarter-on-quarter decline in GDP at that time was not quite as dire as the full ten percent previously estimated. The rapid rebound in the immediately following quarter has been confirmed by the latest data to the extent already estimated. In the overall picture that is now emerging, the kink in the long-term growth path, accompanied by an enduring cumulative output gap, would appear to be a worse knock-on effect of the crisis than the short-term slump in GDP.

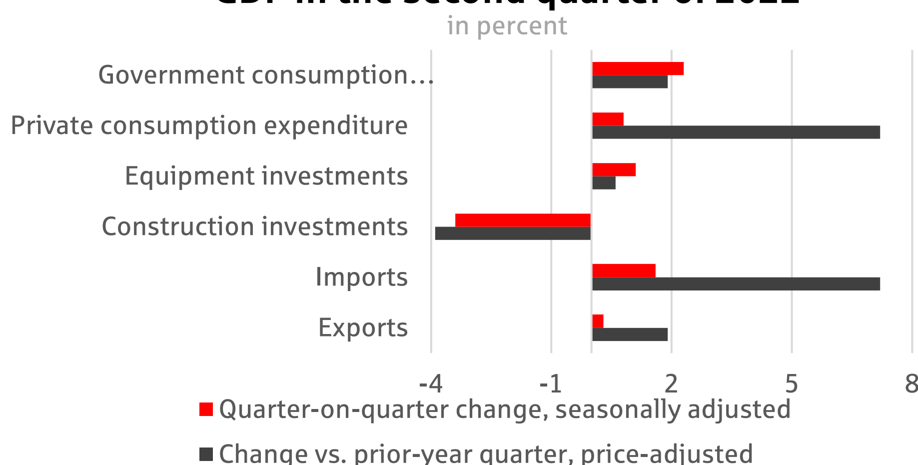
At the present juncture, German GDP is only rising slightly despite favourable domestic demand

After a pleasing start to the year, the economy is moving onto a stagnation path

At the current end of the time series, the latest revision and the initial estimate for second-quarter GDP have brought relatively good news. The opening quarter of 2022 is now reported to be much stronger at 0.8 percent (in real, seasonally-adjusted terms) than the initial estimate of only 0.2 percent suggested. And that was, it should be noted, the quarter when the tally of infections caused by the omicron variant of the coronavirus was reaching its absolute peak in many countries, including Germany! Evidently, Germany was already coping well economically with the virus in that wave. The reopening of business activities and resurgent consumption clearly tipped the scales in the right direction.

For the second quarter, the initial official estimate for price- and seasonally-adjusted GDP growth, released at the end of July, was a flat zero. This figure was likewise then revised slightly just four weeks later to +0.1 percent quarter-on-quarter and +1.8 percent year-on-year.

Expenditure-side components of German GDP in the second quarter of 2022



Source: Destatis

Even though this means that the latest official GDP growth figure for the Federal Republic is only barely above the zero line, it can still be classified as comparatively good news. After all, the second quarter of 2022 was the first period in which the full effects of the war were felt over the entire quarterly phase. Sentiment indicators and other key monthly figures, such as industrial production, had fostered distinctly downbeat expectations and already implied negative growth for the second quarter.

In actual fact, though, domestic consumption paradoxically logged quite a decent rate of expansion. Private consumption was significantly higher than a year earlier, and government consumption was significantly higher too, above all by comparison with the previous quarter. And even plant-and-equipment investment performed well, considering the high level of uncertainty swirling around. Only in the case of construction investment are there signs of a break in the construction cycle after many very strong years. This trend reversal could well intensify in the future after the recent paradigm shift in the interest-rate environment, especially if attempts to accomplish the green transformation of economies do not succeed.

It is important to strictly distinguish between real and nominal growth rates for imports

In straight arithmetical terms, it was primarily the negative showing made by net exports that spoiled the GDP growth performance in the second quarter. And this was solely due to a very sharp rise in imports. The phenomenon in question is difficult to interpret. It is clear that imports have been strongly inflated in nominal terms as a result of the substantial increases in prices. But the calculation of overall GDP is based on real, price-adjusted, imports. The fact that import volumes have also increased so strongly is nothing short of astonishing. After all, the pipeline carrying a not inconsiderable volume of deliveries was already "turned off" in the second quarter. The marked surge in important volumes must be largely attributable to catch-up effects from supply bottlenecks and to a certain tendency to hoard imported goods. Given the concerns about supply chains, quite a number of inventories are being replenished.

Import measurements are strongly influenced by price

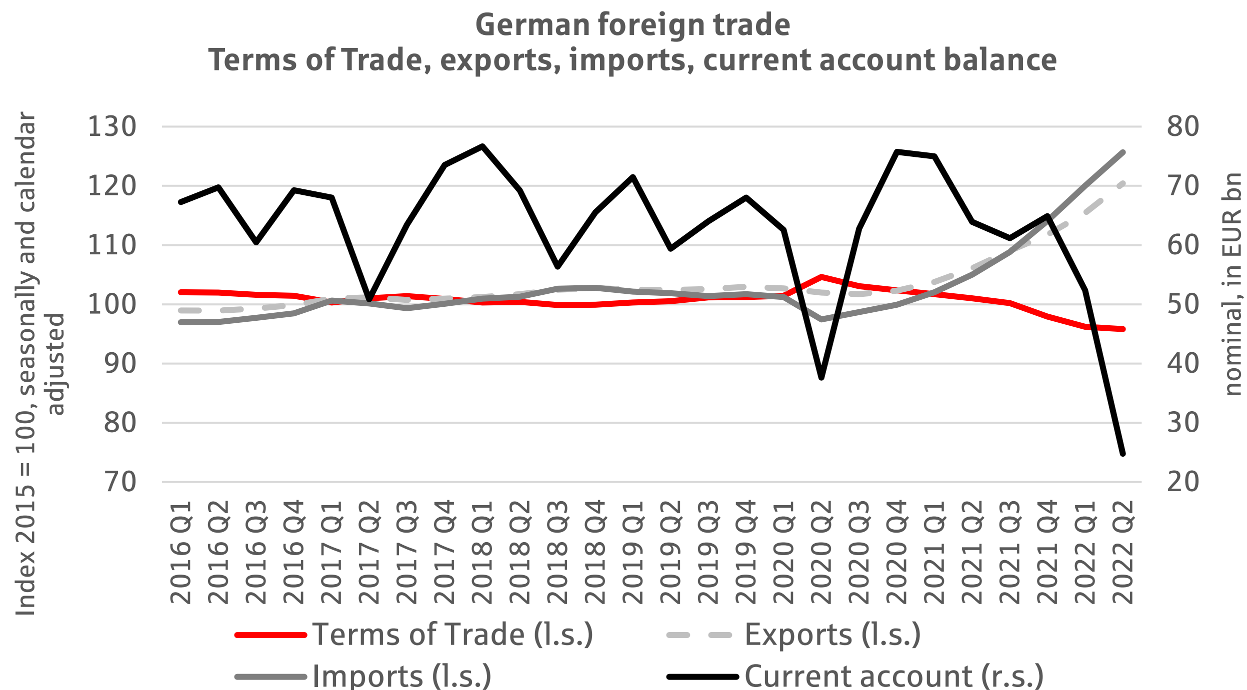
A higher invoice for less delivered goods

In the coming quarters, it will be very important to differentiate clearly between real and nominal developments in foreign trade. Germany's Terms of Trade, i.e. the ratio between a country’s export prices and its import prices, have deteriorated considerably. On account of this shift in "real exchange rates," we are now receiving significantly fewer imported goods in exchange for an equal quantity of German export goods. This is inevitably making the country poorer - the prosperity gains to be derived from foreign trade are eroding.

Germany’s legendarily handsome current-account surplus is fading

What is more, this step change is structural in nature, not temporary, and is definitely likely to stay in place for now. The favourable energy prices that have been available in Germany during recent decades are not likely to make a comeback any time soon. The nominal current-account balance is already in a nosedive as a result of the sharply higher import bill. Germany has invariably achieved very high surpluses in recent decades in this domain -

a state of affairs frequently criticised by foreign countries. In fact, such high current-account surpluses were a reflection of various imbalances, including a very pronounced outflow of high German savings out of the country. In an environment marked by free movement of capital and free exchange rates, these surpluses were market-driven. But market conditions have been transformed out of all recognition in the interim.



Source: Destatis, Bundesbank

The Federal Republic's current-account surpluses are being whittled away to a considerable extent by price trends. On the one hand, this is diminishing the well-known imbalances and tensions, but it is simultaneously spawning new problems. At the very least, Germany is losing the opportunity to "park" a large proportion of its savings in the global economy. Or, to activate another valve on this inexorable accounting machine: the incomes from which these savings used to be created will not be generated at all in the future as a consequence of the changed price ratios!

A country's current-account surplus was, and is, closely correlated with national savings

Annual GDP 2022 = 0.9 + 0.9 +/- X

Turning back to GDP, including foreign trade, which plays such a dominant role in Germany's case: what does the trajectory over the first half of the year mean for 2022 as a whole? In purely arithmetical terms, the road for annual GDP has already been well mapped out: the first quarters not only contribute their respective share, but also determine the starting-level for the subsequent quarters. In keeping with this, the already known rates of change for the first two quarters exercise a disproportionate influence.

The statistical overhang and the opening quarter determine the baseline for annual GDP

2022 got underway with the tailwind of a statistical growth overhang worth almost 0.9 percent. This is the rate by which the year-end figure for 2021 exceeded the 2021 annual average. Germany's economic ship subsequently benefited too from favourable winds in the form of a

surprisingly good start to the year (a first-quarter GDP growth rate of 0.8 percent). The second quarter added the merely incremental growth rate of 0.1 percent already commented on. Factoring in the latter, the aggregate baseline achieved by mid-year rounds up to 1.8 percent. At this level, the performance in the year to date outstrips the average for the previous year. In normal times characterised by positive growth, such a baseline would constitute a secure minimum template on to which growth in the second half of the year could be comfortably bolted.

However, the H2 2022 growth rate is anything but certain. It is more the case that we must brace for a marginal decline in the full-year performance in 2022 if the second half of the year becomes mired in stagnation or even recession. The current projections for the year as a whole are mostly bunched around this mark. All forecast annual figures that are below the "one-point-eight" mark suggest that GDP will decline in at least one of the two remaining quarters - at least if the latest official figures for the first half of the year are taken as a given and if no further revisions to these figures are assumed for the time being.

Joint forecast by the DSGV Chief Economists

A growth rate of 1.4% - i.e. below the 1.8% baseline – implies a mild recession over the remainder of the year

In its summer survey conducted on August 19th, the twice-yearly “Joint Forecast” by nine Chief Economists from the Savings Banks Finance Group produced a main scenario with a median forecast of 1.4 percent for Germany's annual growth rate in 2022. At first glance, this outturn does not look dramatic, looking more like a macroeconomic growth rate in line with the potential growth path.

"Joint forecast" Germany	Reported reading 2021	Forecast 2022	Forecast 2023
Gross domestic product 1)	2.6	1.4	0.0
Private consumption	0.4	2.9	-0.5
Government consumption	3.8	0.6	2.0
Construction investment	0.0	1.6	0.5
Equipment investment	3.5	1.0	-0.1
Exports	9.7	1.5	2.0
Imports	9.0	5.4	3.0
Gainfully employed 2)	44,905	45,500	45,480
Unemployment rate 3)	5.7	5.3	5.5
Consumer prices 4)	3.1	7.7	4.5
Core CPI rate 4) (without energy, food, alcohol, tobacco)	1.9	3.6	3.0
Household disposable income (nominal) 4)	2.1	4.8	4.3
Savings rate 5)	15.1	10.5	9.8

Source: DSGV - Joint forecast by nine Chief Economists from the Savings Banks Finance Group, generated in August 2022.

1) GDP and breakdowns: not calendar-adjusted, real year-on-year change in %.
2) Number of employed persons with place of work in Germany, in thousands.
3) Unemployment rate as defined by the German Federal Employment Agency, in %.
4) Change compared with previous year, in %.
5) Household saving rate as a % of disposable income.

However, such an annual average rate masks the underlying weakness latently present over the course of the year. A growth rate of 1.4 percent figure would not even match the growth rates already generated in the recent past, as explained above. So such a forecast ultimately implies a marginal drop in aggregate economic output over the course of the second half of the year.

For 2023, the "Joint Forecast" then predicts a pure, unadulterated zero for price-adjusted German GDP growth. Since there will be no significant statistical overhang ("growth dowry") from 2022 to 2023, at least not a positive one, a reported figure of zero would be an honest reflection of the prevailing growth dynamics, or rather of their complete absence.

According to this main scenario, we must therefore prepare for six successive quarters of stagnation - or indeed seven, including the already reported second quarter of 2022. The trend will not, of course, be completely linear at zero, but ought rather to oscillate around the zero bound. It is more likely that at least a minor recession will materialise, plausibly in line with the argument about gas shortages, especially in the winter quarters.

Stagflation is now basically the best-case scenario

Stagflation, i.e. a simultaneous stagnation of economic output coupled with the prospect of persistently high inflation in the foreseeable future, is almost the best scenario which seems achievable at present - the title of this issue of "Economic Update" has been chosen in the light of this.

The Euro area economy has outperformed Germany of late - and will likely continue to do so

All the projections contained in the latest "Joint Forecast" are subject to particularly large uncertainty margins at the present time. Yet Germany's ranking in the European league table would seem to be clear: the euro area as a whole was already growing faster than the Federal Republic up to the second quarter of 2022. GDP growth in the currency area as a whole is more clearly exceeding the previous year's level, and is also more clearly above the pre-coronavirus level from 2019. Moreover, the "Joint Forecast" also sees the euro area's prospects going forward as being more favourable. Admittedly, the projected growth rates for the euro area - 3.0 percent in 2022 and 0.5 percent in 2023 - are not exhilaratingly high, especially in the coming year. The strong post-pandemic recovery is coming to an end. But the euro area as a whole will probably be spared a recession. With the exception of the Baltic region, which suffered an even more severe shock because of the Russian invasion of Ukraine due to its geographical location, the entire euro area has recently been performing better than Germany.

"Joint Forecast" Euro area	Reported reading 2021	Forecast 2022	Forecast 2023
Gross domestic product [1]	5.3	3.0	0.5
Consumer prices [2]	2.6	7.9	4.4
Core rate [2] (without energy, food, alcohol, tobacco)	1.5	3.7	4.0

Source: DSGV - Joint forecast by nine Chief Economists from the Savings Banks Finance Group, generated in August 2022.
1) GDP and breakdowns: not calendar-adjusted, real year-on-year change, in %.
2) Change compared with previous year, in %.

Thanks to its pipelines and the way its industrial structure is geared, the Federal Republic is proving to be particularly exposed to the energy shortage.

We have therefore drawn up a separate Downside Risk Scenario for this particular vulnerability in Germany in the current version of the "Joint Forecast." What GDP trend would need to be plotted if gas supplies were to grind to a complete halt, if all gas-saving efforts proved insufficient, and if the gas shortage actually led to draconian rationing measures over the coming winter? In actual fact, the gradual reduction of supply volumes over the past few months has already brought us pretty close to this downside scenario. The residual volumes still arriving only make a difference of degree rather than a difference of kind, but if these were to cease completely, that would once again, nevertheless, be strongly reflected in both GDP and prices.

The DSGV's Chief Economists now put the probability of a complete gas-supply freeze at 30 percent. That would cause GDP growth to slump to 0.5 percent this year and to -3.8 percent next year. Such a turn of events would make another deep recession a reality, effectively the third "recession of a century" in 15 years.

Our downside scenario has a 30 percent probability of being realised

Crisis scenario in the event of a complete halt to gas supplies from Russia - Alternative projections for Germany:

GDP [1)]		Consumer prices [2)]	
2022	2023	2022	2023
0.5	-3.5	8.5	6.0

Source: DSGV - Joint forecast by nine Chief Economists from the Savings Banks Finance Group, generated in August 2022.
1) Real change vs. previous year, in %.
2) HCIP inflation rate, change vs. previous year, in %.

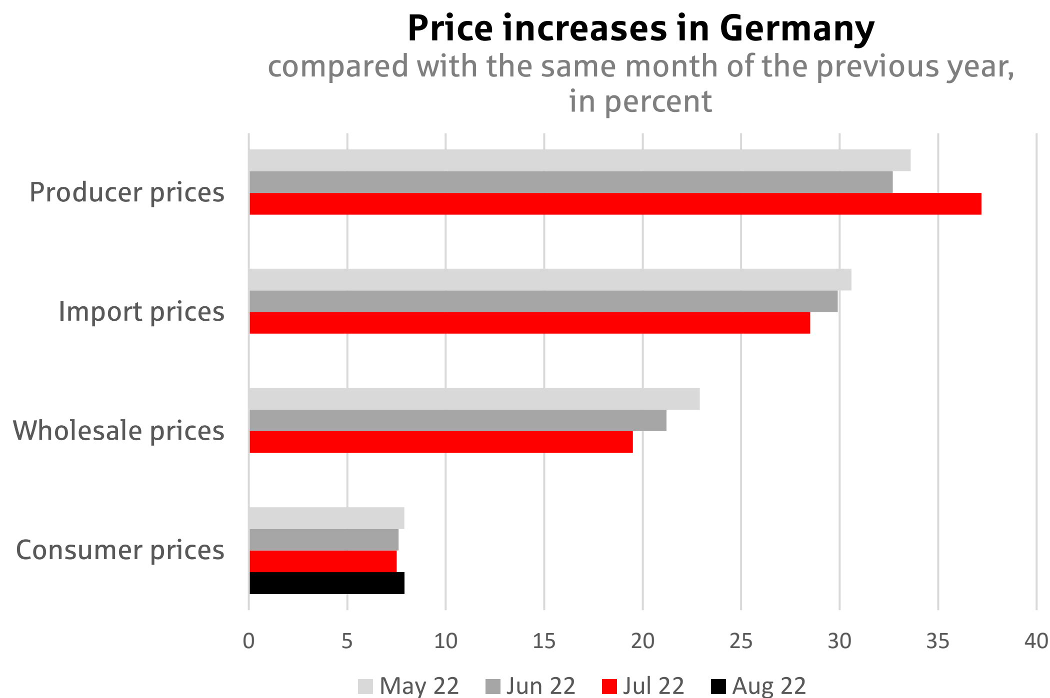
Inflation is going to continue to stalk the stage for a longer period of time

Even without the additional burdens which would be imposed if our risk scenario proved to be correct, inflationary presssure is destined to remain high - in the event of a gas-supply freeze, inflation would presumably turn out to be even more rampant throughout the whole of 2023 and beyond.

Inflation is set to be lower in 2023 than in 2022, but will be broader, affecting more goods categories...
...and is also liable to overshoot the ECB target in the medium

In the main scenario, the "Joint Forecast" estimates an average annual rate of change of 7.7 percent for German consumer-price inflation over 2022. In the coming year, the upward trend in prices is expected to weaken somewhat, partly due to the base effects deriving from the energy category, where prices have already become so expensive. However, at a projected 4.5 percent, overall inflation is poised to remain clearly too high. At the pan-euro area level, the figures are similar: set to hover somewhere between four and five percent, they look like remaining far in excess of the European Central Bank's inflation target in 2023. To make matters worse, inflation is becoming more broad-based across more and more categories of goods, provoking second- and third-round effects. Core inflation rates also remain elevated, with the gap relative to headline rates likely to narrow in 2023.

Ongoing price increases at the upstream stages of the value chain of the order of 30 percent on a year-on-year basis show just how great the pressure continues to be which is being exerted by imports and production costs on price dynamics. This is being illustrated below using the example of the price indices for Germany, but the picture looks very similar in other industrialised countries too.



Source: Destatis

The short-term outlook for inflation in the months immediately ahead is being shaped by a number of special effects on consumer prices arising from new rebates and, on the other hand, from the expiry of other temporary regulations. For example, the phasing-out of the nine-euro ticket enabling unlimited on local and regional transport between June and August, and the expiry of the fuel-tax rebate, are bound to be reflected in Germany's September consumer-price-inflation rates. The gas levy currently under discussion in Berlin would likewise have a price-increasing effect - even though VAT exemptions are being debated in this context. Thanks to the levy, the full increase in the price of gas would be felt more strongly at the consumer level in the first place.

Inflation erodes purchasing power - one of the reasons for the foreseeable stagnation

Such price increases erode purchasing power and slice into household budgets. Although the savings rate is falling - the median projection in the "Joint Forecast" for Germany in 2023 sees the ratio falling to 9.7 percent of disposable income - consumer demand is, at the same time, being reined in by the rise in consumer prices. This is the decisive reason for the prospect of a growth slowdown described above. All the same, the current situation is nevertheless due, at bottom, to a supply-side shock. Theoretically speaking, the braking effect of inflation merely serves to bring demand back into line with supply, which has been reduced by supply bottlenecks, conflicts and sanctions.

Even if the task is a painful one, prices should be allowed to fulfill their allocative function of balancing aggregate supply and aggregate

demand. Otherwise, imbalances will only be prolonged. This is true both in macroeconomic terms, when aggregate demand is constrained by inflation, and in microeconomic terms, in particularly tight markets such as energy.

Caution needs to be exercised when dispensing "relief" measures

Although it is, of course, very understandable that policymakers are searching for new ways to intervene and that new relief packages are being considered on the political stage, there are only limited chances of this feat being accomplished successfully. Dampening certain prices simultaneously dampens the discipline and thrift being practiced in those quarters. Subsidising energy generates traffic, increases consumption, slows heating substitution, and thus exacerbates scarcity.

To allow the price mechanism to do its work is a tough but, at the same time, very effective "economic whip" in times of

We have to be honest enough to take on board that a supply shock, accompanied by a significant deterioration in the Terms of Trade, is inevitably going to curtail prosperity and consumption opportunities. Being able to afford less is unpleasant, but it is also part of the solution in the present situation.

An inflationary spiral has never ever been successfully checked and overcome simply by making more money available!

Inflation has never ever been defeated by simply throwing more money at it!

This is an "iron law" which applies as much to economic and fiscal policy as it does to monetary policy. Breaking the back of rampant inflation requires - undoubtedly painful as it is - a restrictive economic policy.

In this context, it is instructive to take a sideways glance at the United States. It is true that the time frame and main cause of the current bout of inflation differ on the two sides of the Atlantic. In the USA, however, the effects of the expansionary thrust - of the major spending programmes of the Biden administration from 2021 designed to overcome the consequences of the coronavirus pandemic - provide a clear example, proving to be part of the trigger for the inflationary wave that has persisted to this day. Inflationary pressures stateside are of a comparable magnitude to those in Europe, even though the USA is not a net importer of energy and is even a beneficiary of market developments in certain sectors such as LNG. The problem on the far side of the Great Pond is that the strong economic-policy stimuli imparted by the Biden Administration collided with a situation in the USA in which the labour market, brimming over with job vacancies, could hardly have been tighter.

The USA provides a warning example of what happens in the event of a "super-.sized" fiscal stimulus

The labour market is humming along nicely in large parts of Europe too in the interim, and certainly in Germany. The forecasts foresee employment remaining surprisingly robust even in the event of a prolonged stagnation scenario or even of a recession. Structurally speaking, there is not only a long-lamented shortage of skilled workers but also, quite simply, a broad general "labour shortage" in the wake of the re-openings following on from coronavirus-related closures. The effects of demographic change are beginning to show: despite the difficult overall economic situation, new employees are being searched for in all corners. This will also manifest itself as upside pressure in collective wage agreements and - perhaps even more so - in the real wages paid out to workers.

The German labour market is proving highly resilient …

… that in itself is an important piece of good news!

At the same time, this may further exacerbate inflationary dynamics

We are already hearing calls for inflation compensation in the wage rounds currently going on. There is actually no corresponding scope for distribution at present, because the price increases are coming from abroad, through the import channel, and are not an expression of enhanced productivity and rising corporate earnings. The deterioration in the Terms of Trade also "sends its kind regards" at this point. On the contrary, corporate profit margins are coming under additional pressure on account of rising import and producer prices.

Nonetheless, it will not prove in any way possible to prevent nominal wage increases. If these are in line with the scarcity ratios prevailing on the labour market, that is fine, indeed necessary, in order to restore equilibrium in that sphere and to correctly allocate the scarce production factor of "labour." But second-round effects on inflation will inevitably follow from these wage increases. Fiscal policymakers should therefore be extremely cautious about adding fuel to the fire.

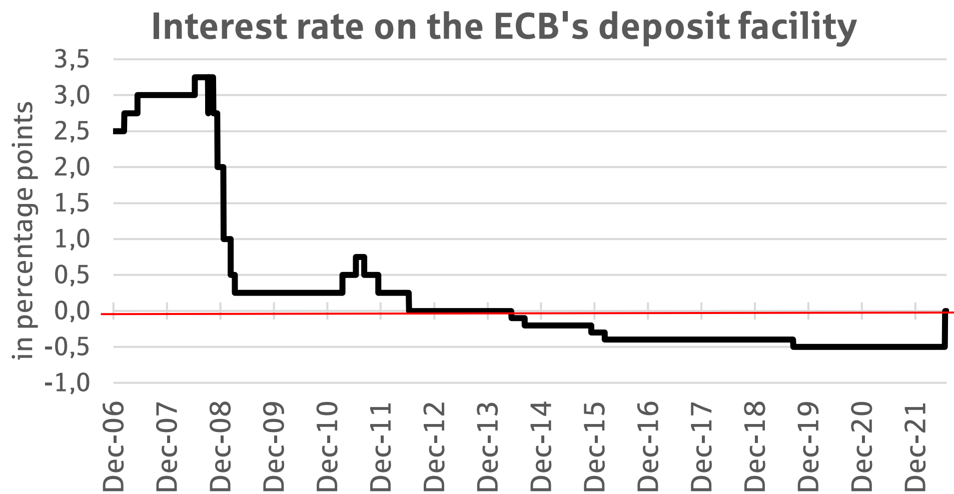
A glimmer of hope - that supply-side shortages may at least be overcome in the case of supply bottlenecks - is being provided on this front by the latest Ifo Business Climate survey. More and more companies are reporting that the problem of supply bottlenecks is no longer as pressing as it was back in the first half of 2022. This simultaneously highlights the adaptability and flexibility of Germany's SMEs, which have further shored themselves up with the help of high inventory buildups. The task now is to continue to strengthen the supply side of the economy in order to be able to grow our way out of the winter stagnation looming in 2022/2023.

A Herculean task is facing monetary policymakers

All the same, the key protagonists in the fight against inflation are the monetary policymakers. The need for action is currently great in many currency areas - in many emerging markets that have already had painful close encounters with high inflation, but also, in the present cycle, in the major industrialised countries as well. The Federal Reserve embarked on its tightening cycle earlier than the European Central Bank and is now further along the road leading to normalisation than the ECB is.

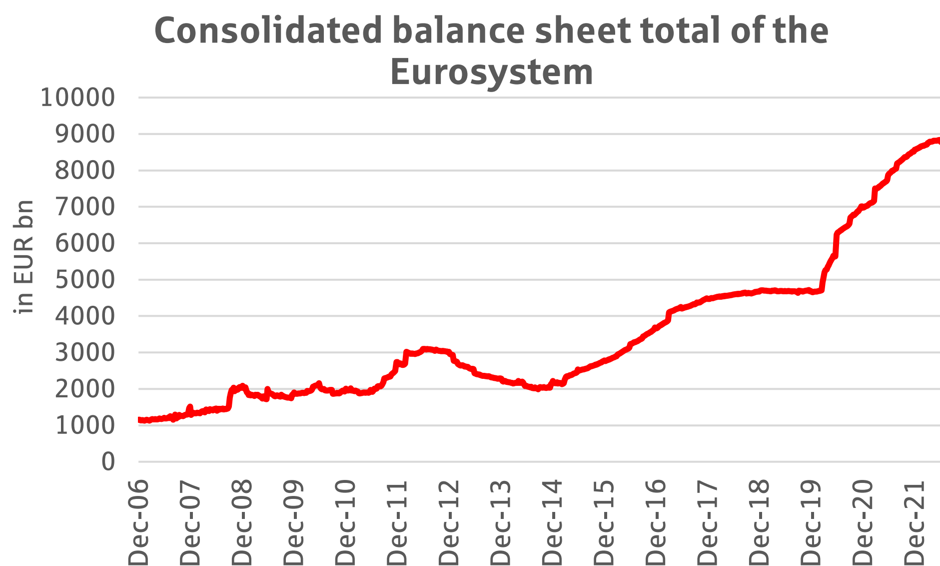
The ECB would also need to "get ahead of the curve"

Yet the ECB also turned the corner in July 2022, initiating interest-rate liftoff. The first key-rate hike from Frankfurt's Twin Towers has turned out to be even larger than previously telegraphed, but more than urgently needed in view of the pace of runaway inflation. On the other hand, the real interest rate (i.e. the nominal interest rate minus the inflation rate) has never been as strongly negative as it is today. This is true even if one does not use the current very high inflation prints, but rather somewhat longer-term inflation expectations, as a benchmark. Yet these too have increased and are beginning to break free from their anchoring to the ECB's inflation target.



Source: Deutsche Bundesbank

However, in the wake of July's 50-basis-point increase in the ECB's policy rates, the euro area has now pulled out of a negative interest rate phase which lasted eight years, at least in nominal terms. In fact, zero or negative interest rates prevailed in the monetary-policy arena for almost exactly ten years. The interest rate on the ECB's deposit facility will remain the relevant key rate for money-market activity for as long as the excess liquidity situation persists. The Eurosystem's purchase programmes and long-term tenders have created far more central-bank money than is needed to cover cash requirements, and for the minimum-reserve requirements which credit institutions are obliged to comply with.



Source: European Central Bank

Balance-sheet reduction in the euro area is still music from a long way off

In the medium to long term, the issue of the Eurosystem's ballooning balance-sheet total will also need to be addressed. The Federal Reserve is further ahead on this front as well, having started to run off its holdings. In the euro area, an initial balance-sheet-trimming effect will only emerge when the TLTRO programmes expire in 2023 and 2024. Actively reducing portfolios is more difficult, furthermore, in Europe's

case because the holdings continue to be used to smooth spreads on the capital market. Regarding reinvestments of maturing principal payments from the Pandemic Emergency Purchase Programme (PEPP) (although net asset purchases under the PEPP have been discontinued, maturing principal payments continue to be reinvested), it is an open secret that German government bonds maturing in the portfolio are, in de facto terms, swapped for Italian government bonds.

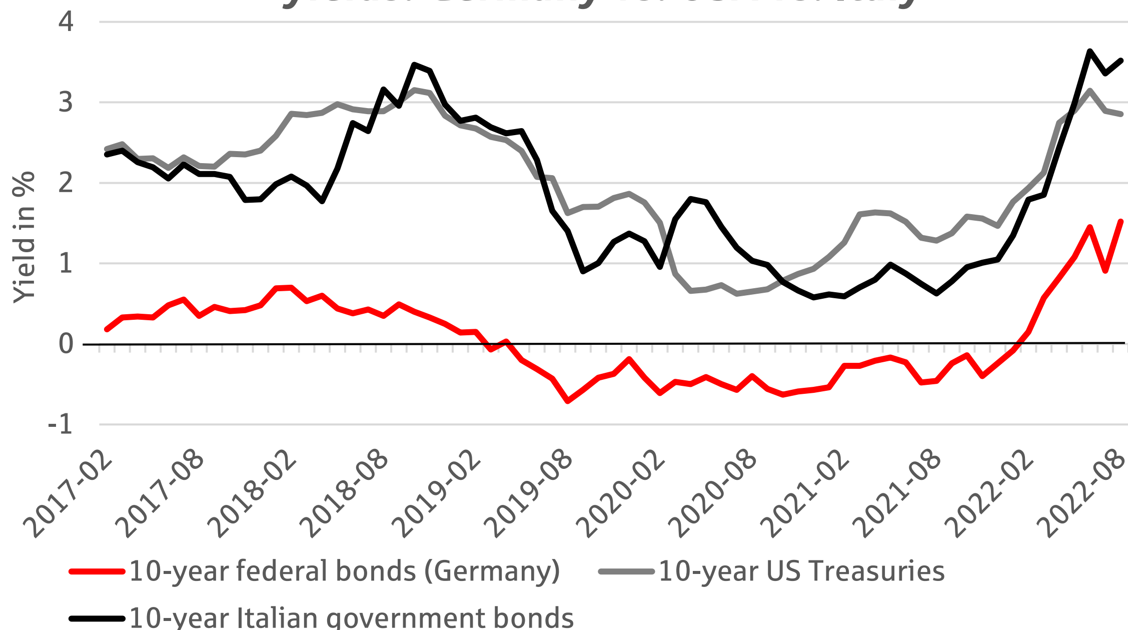
Though their effect on the money supply is - rightly! – expected to be sterilised, TPI interventions promise only limited success in terms of spread containment

And this does not yet take into account the new Transmission Protection Instrument (TPI), which is intended to limit euro area spread widening through even more active intervention in the event of an escalation. In any case, this instrument raises many legal and political questions and involves problems of practicability. In addition, the ECB would probably need to sterilise the impact on the money supply of any purchases under the TPI with the help of other instruments in order to maintain the credibility of its underlying monetary-policy approach to fighting inflation. That, in turn, would limit the effectiveness of the interventions with respect to the target interest rate. The experience gathered in ealier years with sterilised foreign-exchange market interventions certainly implies that TPI interventions would only be of limited effectiveness.

Let us hope that the TPI's functionality will not be questioned and tested by the capital markets. On a best-case scenario, this supposed ”anti-fragmentation tool” will not have to be activated in the form of actual purchases, but will have an effect simply by being announced, by showcasing the Eurosystem’s will to act, as was once the case with the Outright Monetary Transactions (OMT) programme. At the time of its launch in 2012, however, the OMT had the tailwind of a synchronised expansionary monetary policy at its back, and that would now no longer be a responsible policy option.

In recent weeks, at least the spread between German and Italian government-bond yields has remained reasonably stable. The spread on Italian public bonds over maturity-congruent German securities (BTP/Bund spread) spiked especially at the apex of the general surge in capital-market yields in June, but has subsequently retraced somewhat.

At the beginning of August, capital-market yields in the euro area actually fell back sharply again. The reason for this was a "flight to safety" during the stand-off across the Taiwan Strait. Most recently, however, bond yields have moved northwards once more, reflecting expectations of progressive monetary tightening in the face of high inflation.



Source: Deutsche Bundesbank, FRED, Banca d'Italia

Normalisation of policy rates on a step-by-step basis has to be, and will be, continued with

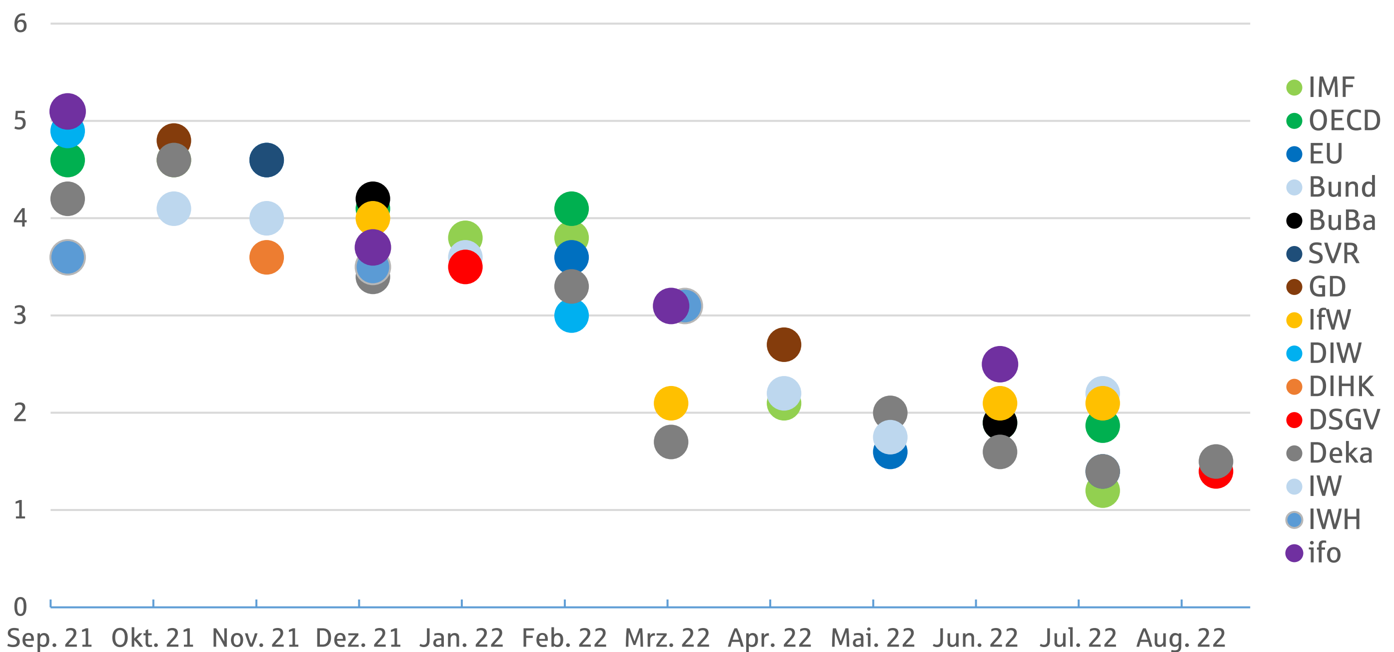
The ECB has, to all intents and purposes, already firmly announced a further interest-rate step for its Governing Council meeting on September 8th 2022. This will again be a major step of at least 50 or even 75 basis points. After that, Team Lagarde will have to continue, step by step, with further policy-rate hikes until inflation momentum has been brought under control. At the moment, monetary policymakers simply cannot afford to take into account the stagnating or even recessionary macroeconomic situation in the euro area or in parts of it. This was also impressively demonstrated by the meeting of major central bankers at Jackson Hole in late August.

A. Growth of the world's economic regions, year-on-year change

	2020	2021	2022*	2023*
World trade volume	-7.9%	10.1%	4.1%	3.2%
GDP – World	-3.1%	6.1%	3.2%	2.9%
USA	-3.4%	5.7%	2.3%	1.0%
Japan	-4.5%	1.7%	1.7%	1.7%
China	2.2%	8.1%	3.3%	4.6%
Euro area	-6.4%	5.4%	2.6%	1.2%
Germany	-4.6%	2.6%	1.2%	0.8%

* International Monetary Fund projections from July 2022

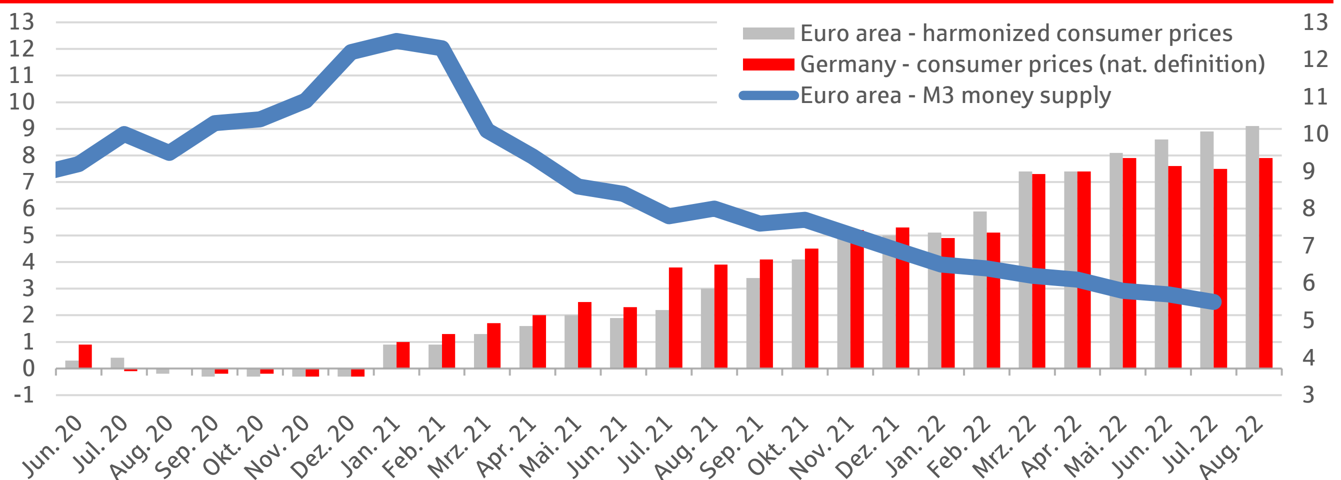
B. Economic growth forecasts for Germany for 2022, in %.



C. GDP in Germany and the euro area

	Full-year 2021 real vs. prior year	Q III - 2021	Q IV - 2021	Q I - 2022	Q II - 2022
		Real change versus prior-year quarter and seasonally-adjusted real change compared with the previous quarter			
Euro area GDP	+5.4%	+3.9% +2.3%	+4.8% +0.4%	+5.4% +0.5%	+3.9% +0.6%
Germany GDP	+2.6%	+1.8% +0.8%	+1.2% 0.0%	+3.9% +0.8%	+1.8% +0.1%
Private consumption	+0.4%	+1.4% +5.7%	+3.1% -1.0%	+8.8% +0.8%	+7.2% +0.8%
Gross capital investment	+3.5%	+0.0% -2.3%	-2.3% 0.0%	+2.0% +2.1%	-1.6% -1.3%
Exports	+9.7%	+7.4% 0.0%	+7.2% +2.5%	+3.4% -0.7%	+1.9% +0.3%
		Level, not rate of change; quarterly figures, seasonally adjusted			
Savings rate	15.1%	12.0%	12.2%	11.4%	10.8%

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



E. Monthly economic indicators Germany

	April	May	June	July	August
Prices (national definition)	Change from the same month of the previous year				
Consumer prices	7.4%	7.9%	7.6%	7.5%	7.9%
– Excluding food and energy (core inflation)	3.8%	3.8%	3.2%	3.2%	-
Producer prices for industrial products	33.5%	33.6%	32.7%	37.2%	-
Import prices	31.7%	30.6%	29.9%	28.9%	-
Sentiment indicators					
ifo Business Climate Index	91.9	93.1	92.2	88.7	88.5
ZEW Economic Sentiment Survey	-41.0	-34.3	-28.0	-53.8	-55.3
Incoming orders	Change compared to the same month of the previous year				
Manufacturing industry	-8.0%	2.8%	-11.6%	-16.1%	-
from within Germany	-4.6%	3.2%	-15.8%	-18.1%	-
from abroad	10.5%	2.6%	-8.4%	-14.6%	-
Capital goods producers	-10.0%	3.4%	-13.5%	-20.9%	-
Production	Working-day-adjusted change compared to the same month of the previous year				
Overall manufacturing industry	-2.5%	-1.7%	-0.5%	-	-
Thereof: construction	-1.7%	-3.6%	-2.9%	-	-
Thereof: industry	-3.0%	-1.5%	0.0%	-	-
Foreign trade	Change compared to the same month of the previous year				
Exports	9.3%	21.7%	14.5%	-	-
Imports	26.1%	34.5%	24.8%	-	-
Labour market	Unemployment rate / change in the jobless total compared to the same month of the previous year (1,000s)				
Unemployment rate	5.0%	4.9%	5.2%	5.4%	-
Jobless total	-439	-476	-465	-462	-
Employed persons (with place of work in Germany)	628	698	735	-	-
Employees subject to social-security contributions	656	720	-	-	-

F. Commodity, foreign exchange and financial markets

	May	June	July	August	6th Sept
Brent **oil price** in US $	113.34	122.71	111.93	95.06	- -
Exchange rates					
US dollar / EUR	1.0579	1.0566	1.0179	1.0030	0.9928
Japanese yen / EUR	136.24	141.57	139.17	136.07	140,91
Stock markets					
DAX German benchmark share index, end of month	14,388	12,783	13,484	12,835	12,795
Change compared to the same month of the previous year	-6.7%	-17.7%	-13.3%	-18.95%	-
Money and capital market interest rates					
Call money (€STR)	-0.585%	-0.582%	-0.511%	-0.085%	-0.087%(5th)
1-month money (EURIBOR)	-0.55%	-0.53%	-0.31%	0.02%	0.30%(5th)
3-month money (EURIBOR)	-0.39%	-0.24%	0.04%	0.40%	0.78%(5th)
Current yield of German federal Treasury bonds (Bunds) with a residual maturity of ten years	1.08%	1.45%	0.91%	-1.52%	1.51%
Interest rates of credit institutions, in new business					
Daily deposits of private households in Germany;	-0.02%	-0.02%	0.00%	-	-
for comparison across the euro area	0.01%	0.01%	0.01%	-	-
Deposits from private households up to 1 year in DE;	0.14%	0.17%	0.31%	-	-
for comparison across the euro area	0.18%	0.19%	0.27%	-	-
Corporate loans of up to € 1 million over 5y in DE	2.31%	2.59%	2.91%	-	-
for comparison across the euro area;	1.84%	1.95%	2.14%	-	-

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