HOW INTENSE WILL THE RECESSION BE?

Unexpected to say the least, +0.4% growth in German GDP in the third quarter should not distract from the bigger picture. While the power of the end of catch-up effects surprised the consensus which did not expect such dynamism in activity in the third quarter, there is no doubt that German growth drivers are fading one by one under the weight of an extremely unfavourable economic climate: record inflation, energy crisis, drop in global demand... After a last stand in Q3, it therefore seems unlikely that Germany could continue to post positive growth over the last three months of the year. While Germany's entry into recession is almost confirmed, the question of how intense it will be is much more up in the air.

In the third quarter, German GDP fully benefited from the end of catch-up effects, posting unexpected growth of +0.4% (q/q) after +0.1% in the second quarter. This increase in activity was made possible by the recovery of demand items, which were still operating well below their pre-Covid level. This is the case for private consumption, buoyed by spending on services, particularly in catering and accommodation, which grew by +1% in the third quarter (q/q). But this also concerns investments in machines and equipment, which started from a very low level and increased by 2.7% (q/q) without however returning to their level at the end of 2019 (-2.5%).

A DETERIORATED ECONOMIC SITUATION THAT IS WEIGHING ON GROWTH DRIVERS

These almost mechanical rebound effects must not make us forget the extremely unfavourable context Germany is in. Companies and households are the first to express their concerns in economic surveys. Business leaders' sentiment over the current situation has reached a record low in November since the beginning of the year, according to the IFO survey. In each sector of the economy, the climate is well below its long-term average: services (-23 pts), retail (-20 pts), wholesale (-20 pts), industry (-16 pts), construction (-6 pts). And consumer confidence fell sharply in December (-44 pts below its long-term average).

While the radical message sent by surveys is not fully reflected in the hard data, the fall in many indicators has already been visible since the beginning of the year. Industrial production is down 2.3% year-to-date and shows no sign of improvement, as demand for the industry is declining completely with new orders falling 12% year-to-date. The corollary of this weakening of industrial production is the loss of dynamism of German exports. With one exception in the first quarter of 2022, external trade has contributed negatively to growth since mid-2021. The deterioration of the trade balance is massive: at the beginning of 2022, Germany still had a surplus of more than EUR 10 billion per month, whereas in September this surplus was only EUR 4 billion.

On the domestic demand side, household consumption is held back by double-digit inflation that erodes purchasing power. This can be seen in particular in the consumption of goods with retail sales falling by 5% since the beginning of the year. As far as investment is concerned, companies are cautious in the realisation of their investment projects, since uncertainty about future activity is high. This caution has led to investments always falling below their pre-crisis level, and investments in machine tools and heavy equipment are particularly suffering from the poor business climate.

THE INFLATION PIVOT

German inflation is constantly breaking records with consumer prices rising by +10% year-on-year in November. Going back to just after the Second World War, inflation reached +11.4% in October 1951 as a result of virulent deflation over the whole of 1950. This inflation continues to be driven by energy prices, since electricity prices (+26% y/y in October), gas prices (+74% y/y in October) and coal prices (+102% y/y in October) are not slowing down. In the face of the energy impact, manufacturers passed on part of their increase in production costs in their sales price, as evidenced by the rise in prices of goods in November,

GROWTH & INFLATION

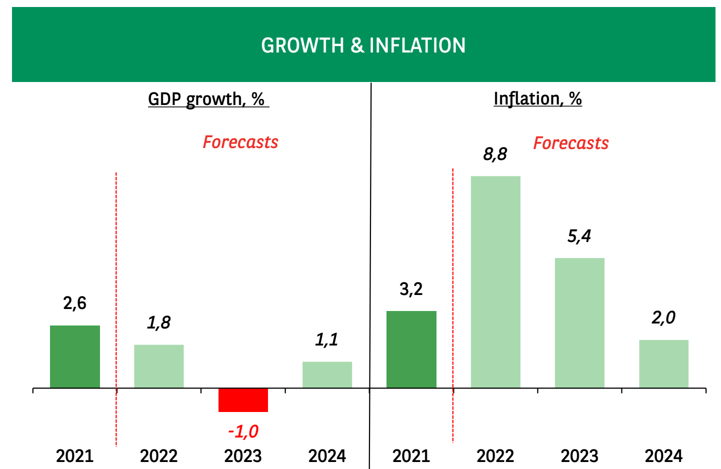

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

EMPLOYMENT IN GERMANY

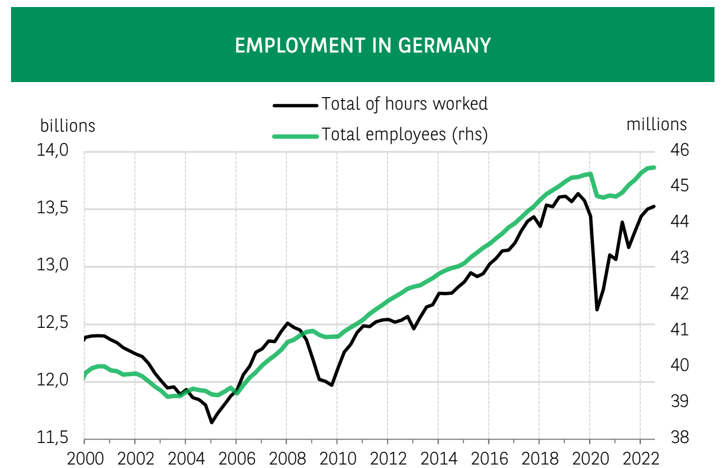

CHART 2 SOURCE: DESTATIS, BNP PARIBAS

which stood at +17% (y/y) compared with only +3.7% in services (y/y). However, this excessively high inflation is not expected to last over time and the first signs of a dip are appearing. Firstly, inflation fell slightly between October and November (from +10.4% y/y to +10% y/y), possibly indicating a pivot in the tenth month of 2022. Secondly, producer prices in industry, which are upstream of consumer prices, fell sharply, from +45.9% year-on-year growth in September to +34.6% in October. The same applies to wholesale prices (+17.4% in October year-on-year, after +19.9%).

As this inflation is not accompanied by such a significant revaluation of wages, households' purchasing power is suffering. In fact, the hourly wage per employee (including bonuses) slowed sharply in the third quarter to +2.2% year-on-year (after +5.4% in the second quarter). This has led the OECD in its latest economic outlook to highlight that real wages per capita fell by more than 4% (y/y) in the third quarter in Germany.

Furthermore, the last salary renegotiations obtained by the powerful IG Metall union will not allow salaries to catch up with prices. The agreements concluded for electrometallurgy workers provide for a 5.2% increase in salaries in June 2023, followed by a 3.3% increase on 1 May 2024, accompanied by a bonus of EUR 3,000, which will be divided into two tranches, one in March 2023 and the second in the following year. A first costing of these agreements shows that the overall increase in income for these four million employees should be in the region of 5.6% in 2023, then 4.6% in 2023. However, this calculation does not take into account companies that will be removed from collective agreements due to their excessively deteriorating financial situation. However, it is possible that a larger than normal share of companies may withdraw from sectoral agreements, since the spike in production costs is straining companies' margins and profitability.

A DECEPTIVE LABOUR MARKET

As in the rest of Europe, the labour market has weathered the multiple shocks affecting the economy. The ILO unemployment rate stands at its pre-Covid level at around 3% and the number of people employed in September was 0.4% above its end-2019 level. However, this momentum came to a halt last May, since net job creation has since been 0%. In addition, a specific feature of the German market is that the number of hours worked is still below its pre-Covid level (-0.4%). In other words, the number of people employed has increased, but a proportion of the contracts offered have been precarious with a rise in restricted part-time contracts.

The crisis also accelerated sector divergences. While some sectors have massively hired labour since the end of 2019 such as information & communications (+8.4%) or the public sector (+4.6%), others have destroyed jobs such as the manufacturing sector (-3.1%) or the retail and accommodation/catering sector (-1.7%).

At the same time, recruitment difficulties have increased considerably. In the fourth quarter, 41% of industrial companies (compared with 16% in Q4 2019) mentioned the lack of labour as a limiting factor in their production in the European Commission's survey. This rate reached 38% in the construction sector and 41% in the services sector (compared with 13% and 27% respectively in Q4 2019). This was in a context where the rate of vacancies was at a record level (4.8% in Q3 2022 compared with 3.4% in Q4 2019). This indicates a deterioration in the labour market's matching ability.

HISTORIC GOVERNMENT SUPPORT

Despite a delay in public intervention in comparison to other European countries, the German government decided to intervene massively to support its economy. This should allow the country to experience only a moderate and limited contraction in activity over time.

On 4 September, Olaf Scholz announced a new package of measures[1] for an amount of EUR 65 billion, followed on 29 September by a «defence shield» of EUR 200 billion[2]. This budget will finance the maintenance of a reduced VAT rate on energy at 7% until spring 2024 and the capping of gas and electricity prices for households and businesses. The government will subsidise 70% of companies' normal gas and electricity consumption (based on last year's consumption) and 80% of household consumption. With regard to pricing, the cap on gas prices for companies will be set at 7 cents per kilowatt hour (kWh) compared to 12 cents per kWh for households (except for heating: 9.5 cents per kWh). For electricity, the mechanism provides for a limit of 40 cents per kWh for households and 13 cents per kWh for large companies. All of these measures should enter into force on 1 January 2023, except for the gas price limit for households, which should enter into force on 1 March 2023 but which could ultimately be brought forward to 1 January, according to information from the government.

As a reminder, the average annual gas bill for a German household has increased by 250% in a year, according to data from the energy price comparison tool Check24. As an example and based on the October prices when the price per kWh came out at EUR 0.186, the introduction of the price cap will save slightly more than EUR 1,000 for an average household with a consumption of 20,000 kWh per year. The Ministry of the Economy estimates at this stage that the scheme should cost the Federal State EUR 54 billion by the end of April 2024, of which EUR 21 billion will be intended for companies. These estimates remain very uncertain as they are based on price assumptions for gas and electricity.

This massive public support, the total amounts of which announced exceed 8% of GDP, will make it possible to significantly relieve the production costs of industrial companies and thus preserve their profitability and export competitiveness. Because the great fear of the German government is the prospect of seeing its industrial fabric crumble or relocate to the other side of the Atlantic Ocean in the United States. In addition, transfers to private individuals will help support households' purchasing power in 2023 in order to best preserve household consumption.

Finally, public support for the activity should also be reflected in dynamic public consumption, as seen since the post-Covid recovery. In fact, consumer spending carried out by the public authorities has increased by 0.8% on average per quarter since the start of the Covid crisis, representing an increase in quarterly public consumption of EUR 14.4 billion between Q3 2022 and Q4 2019.

Germany is therefore unlikely to escape an economic recession, but a relatively short and shallow recession is the most plausible scenario.

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1 See EcoWeek of 19 September for details of measures
2 See EcoWeek of 17 October