GERMANY

AFTER IMPORTED INFLATION, DOMESTIC INFLATION?

Germany is one of the Eurozone countries hit hardest by the Russia-Ukraine war, which is leading towards feeble growth prospects and high inflation. German GDP is expected to barely increase by 1.3% in 2022, compared to a Eurozone average of 2.5%. Average annual GDP growth will remain 0.9% below the year-end 2019 level. At the same time, inflation is expected to reach 8.1% in 2022, driven up by high energy prices. Between the minimum wage hike promised by the government and expected wage increases in many sectors, wage growth should accelerate strongly in 2022, but may not be sufficient to offset the inflationary shock.

Germany has significantly reduced its energy imports from Russia (by about 35% since the outbreak of the war) by increasing natural gas shipments from Norway and the Netherlands, and by ramping up imports of liquefied natural gas (LNG). Yet supply troubles and the geopolitical context have placed a heavy strain on the economy. Although GDP -driven entirely by investment-grew a slight 0.2% q/q in Q1 2022 , household consumption and the trade balance both contracted, squeezed by the war in Ukraine. Q2 prospects have deteriorated. Consumption contracted in April, with retail sales down 5.4% m/m, while foreign trade has slumped. The Kiel Institute's leading indicator on trade suggests that the trade balance will plunge in Q2 to its lowest level in two decades. Lastly, business leaders have very low expectations of future business: the executives and analysts surveyed by the IFO and ZEW are clearly pessimistic (balance of -17.8 in May and -27.6 in June, respectively). The same goes for household expectations (-9.3 in May) (see chart 2).

The geopolitical environment has sharply driven up energy and commodity prices. Inflation rose to 7.9% y/y in May, a record high since February 1952 for West Germany. It is mainly fuelled by energy prices (+38.3% y/y in May), but inflation is also spreading to goods (+13.6% y/y) since many companies have already carried over part of the increase in production costs to their end prices. Although inflation has not yet spread to the services sectors (+2.9 y/y), the programmed increase in the minimum wage (from EUR 9.82 currently to EUR 12 in October) could change the situation since it will touch numerous sectors (temporary employment, cleaning and security services). Even so, it seems fairly unlikely that Germany will be hit by a price-wage spiral. Despite a favourable environment for wage talks, with a very low unemployment rate (3% according to the ILO definition in May) and the job vacancy rate at an all-time high (4.1% in Q1 2022), inflation is too high to be fully offset by wage increases. Wage talks between labour unions and management since the beginning of the year seem to be heading towards an average wage increase of 4%, not including bonuses, but that will not be enough for average household purchasing power to hold in positive territory.

Faced with the inflationary shock, the government is providing only minimum support to households and companies (limited assistance with strict compliance criterion). The public deficit will barely reach 2.5% of GDP this year (compared to 3.7% in 2021). Christian Lindner, the Finance Minister, intends to comply with the constitutional stipulation limiting the Federal government's structural deficit to 0.35% of GDP. Moreover, beginning in 2022, the government has begun to sharply reduce the public debt ratio (by about 3 points of GDP). The only manoeuvring room could come from the creation of a special off-balance sheet fund, the cost of which would not appear on the Federal government's public deficit, as was the case for the recently-approved EUR 100 bn investment plan for defence.

GROWTH & INFLATION

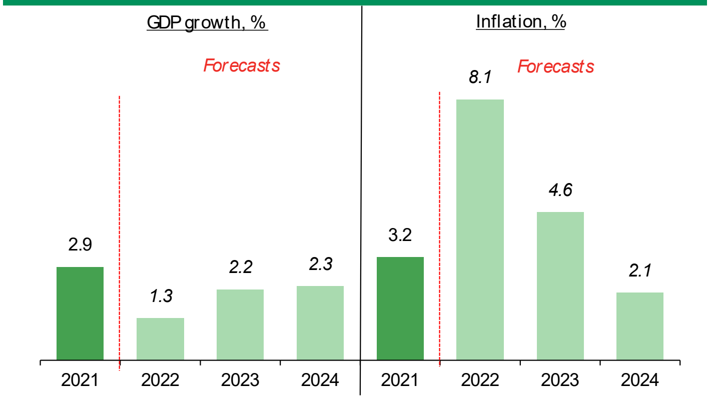

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

GERMANY: BUSINESS EXPECTATIONS

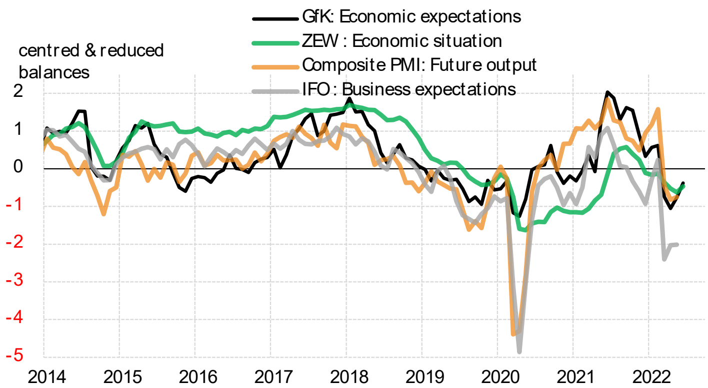

CHART 2 SOURCE: IFO, ZEW, GFK, S&P GLOBAL, BNP PARIBAS

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