WEEK AHEAD | ECONOMY, GOVERNMENT BONDS| EZ

Why is Germany's economy so weak?

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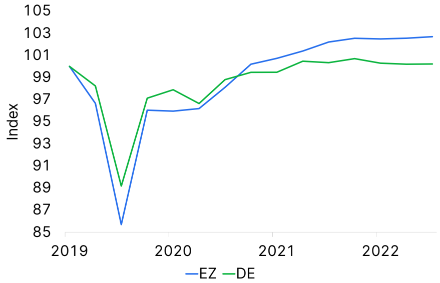
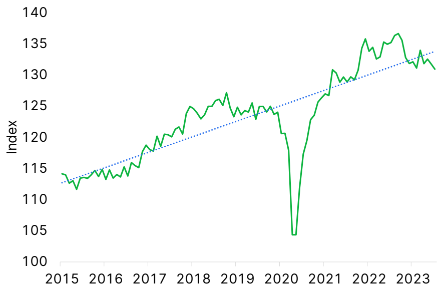
GDP-index Eurozone vs. Germany



Source: Eurostat, Erste Group Research

World trade index vs. linear trend



Source: Eurostat, Erste Group

Germany suffers from high dependence on manufacturing and world trade

Germany's economy has already been stuck in a phase of stagnation for several quarters. A comparison with the growth momentum of the Eurozone shows that Germany's growth has already been below-average compared with the other Eurozone countries since mid-2021.

In our view, Germany's high dependence on manufacturing and global trade play a key role in this development. While the average contribution of the manufacturing sector to value added in the Eurozone is around 17%, Germany's contribution is significantly higher at 21%. However, following an overshoot at the height of the pandemic, the manufacturing sector has been facing continuously declining demand since the end of 2021. One of the reasons for this is that global demand has begun to focus more on services again since the end of the pandemic. Countries with a high dependence on tourism (e.g. Italy and Spain) were able to benefit from this.

The weakness of global manufacturing is also reflected in continued stagnation in world trade. After overshooting in 2021 and 2022, the volume of world trade during the last few months has again fallen well below the growth trend of recent years. Against the backdrop that there is likely to have been a significant build-up of inventories in 2021 and 2022 (among other things to mitigate supply chain problems), the ongoing slowdown in global trade is understandable. However, given the high importance of foreign trade (German exports account for around 50% of GDP), this development is hitting Germany harder than average.

Looking ahead to 2024, once inventories have returned to normal, we expect a gradual recovery in world trade and thus also in manufacturing. In our view, Germany's economy should be able to benefit from this to an above-average extent. We therefore forecast that Germany should return to growth in 2024, in line with a recovery in global industry.

In the medium term, however, Germany should focus on strengthening domestic consumption in order to reduce the economy's dependence on fluctuations in the global manufacturing cycle. In this context, it would be important, among other things, to provide sustainable tax relief for lower-income earners and second earners.

Bond markets within the Eurozone on the move

The end of this week marks the deadline for EU countries to submit their budget drafts for next year and the years ahead to the European Commission for assessment. Of the major countries, Italy and France seem likely to show little effort to reduce their deficits. While this is certain for France, there are no official figures for Italy as yet. However, the media has reported a much higher deficit this year than originally forecast and a relatively small reduction in the deficit next year. Spain is still in the midst of forming a government, so there is uncertainty as to what the final budget will look like. Germany will reduce the deficit in 2024 compared with 2023 and thus remain well below the

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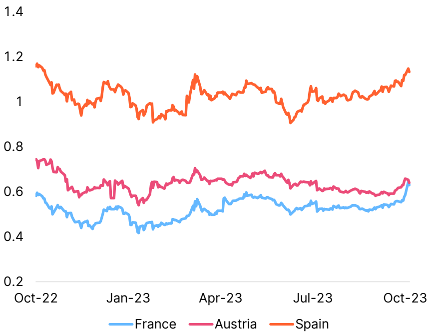
Maastricht limit of 3% of GDP. The Maastricht criteria are currently suspended, but only until spring 2024. However, it is open whether or how quickly these budget rules will be fully reinstated. There will probably be a heated debate about this within the EU next year. In any case, more pressure for budgetary discipline should be assumed for next year.

10y government bond spread Italy vs. Germany, in percentage points

Source: Market data provider, Erste Group

In the immediate term, however, the postponement of budget consolidation in some countries could cause unrest on the market and spreads (yield premiums) could rise further. Energy prices have already fallen significantly and thus lower subsidies should actually reduce government deficits noticeably. In addition, higher interest rates will put increasing pressure on budgets during the coming years and 'room' should be made for this. Due to the high debt of more than 140% of GDP, the Italian budget will probably be a focus for the markets. Italian spreads in the 10-year range have recently risen again to more than 200 basis points, which is as high as they were at the beginning of the year. Amid the strong increases of bond yields in the course of September in general, spreads of many Eurozone sovereign bonds against Germany increased, albeit mostly only to a small extent.

10y government bond spreads vs. Germany, in percentage points



Source: Market data provider, Erste Group

The ECB has a number of tools to intervene in the market should a country's sovereign bonds experience a sell-off, thereby limiting the impact, but not to prevent spread widening. Monthly redemptions from the PEPP program, which was created to purchase bonds when the pandemic broke out, can be flexibly reinvested. The next stage would be the Transmission Protection Instrument (TPI). The Governing Council of the ECB decides on the use and thus on the purchases of an issuer's (country's) bonds. However, this tool is only used if financing conditions (costs) deteriorate to an extent that is not in line with fundamentals. Spreads must therefore already increase significantly before the TPI is used. Also, a number of criteria must be met for the TPI to be adopted. Finally, there are Outright Monetary Transactions (OMT), which are only used if a state receives money from the Eurozone rescue fund (ESM) and shows willingness to implement a restructuring program, i.e. in extreme cases.

Economic calendar

Ctry	Date	Time	Release	Period	Consens	Prior
Eurozone						
USA						
	17-Oct	14:30	Retail Sales mom	Sep		
China						
	13-Oct	3:30	Inflation y/y	Sep		

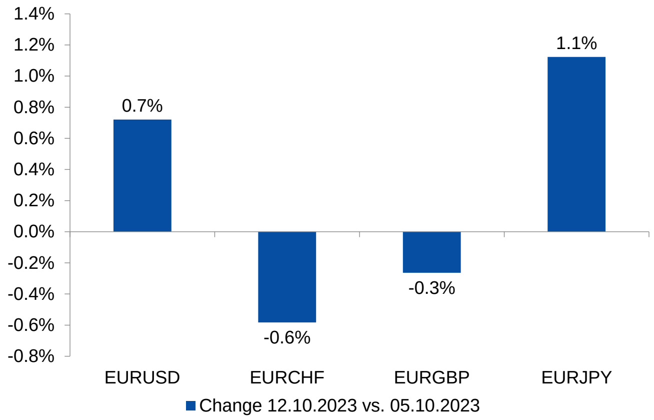
Central bank events

	Date	Time	Representative	Forum	Location
ECB			The current calendar will be available on the ECB homepage from 12:00h on 13.10.		
			Weekly schedule of public speaking engagements and other activities (europa.eu)		
Fed			No monetary policy relevant events		

Source: Market data provider, ECB, US Fed, Erste Group Research

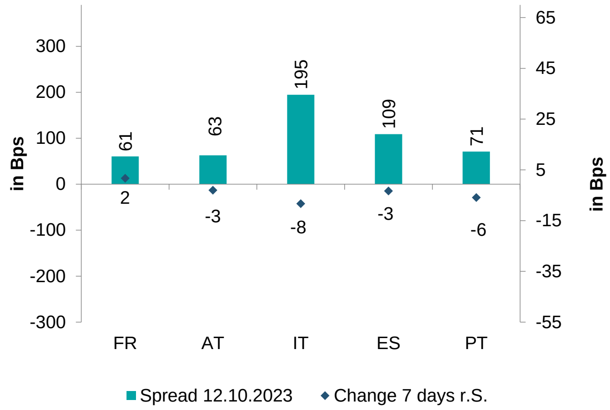
Forex and government bond markets

Exchange rates EUR: USD, CHF, GBP and JPY
Changes compared to last week



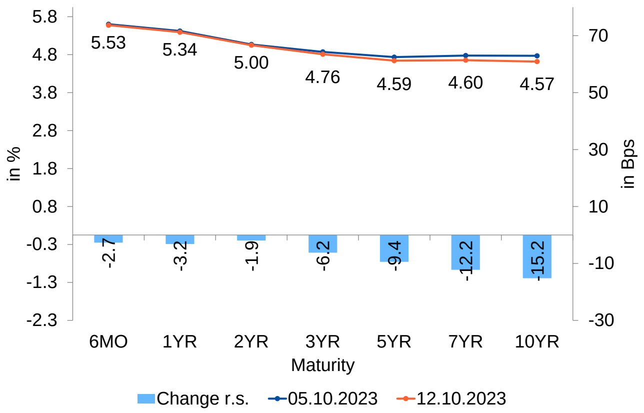
Source: Market data provider, Erste Group Research

Eurozone spreads vs. Germany
10Y government bonds



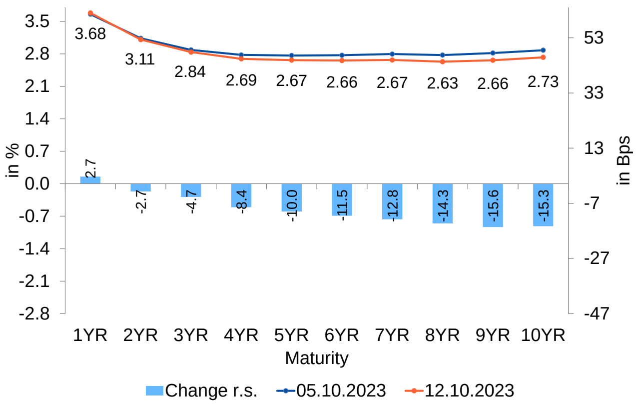
Source: Market data provider, Erste Group Research

US Treasuries yield curve
Changes compared to last week



Source: Market data provider, Erste Group Research

DE Bund yield curve
Changes compared to last week



Source: Market data provider, Erste Group Research

Forecasts[1]

GDP	2021	2022	2023	2024
Eurozone	5.3	3.5	0.5	1.2
US	5.9	2.1	2.0	1.1

Inflation	2021	2022	2023	2024
Eurozone	2.6	8.4	5.7	3.0
US	4.7	8.0	4.1	2.5

Interest rates	current	Dec.23	Mar.24	Jun.24	Sep.24
ECB MRR	4.50	4.50	4.50	4.25	4.00
ECB Deposit Rate	4.00	4.00	4.00	3.75	3.50
3M Euribor	3.95	3.99	4.02	3.79	3.57
Germany Govt. 10Y	2.73	2.40	2.40	2.40	2.40
Swap 10Y	3.29	2.90	2.90	2.90	2.90

Interest rates	current	Dec.23	Mar.24	Jun.24	Sep.24
Fed Funds Target Rate*	5.33	5.38	5.38	5.13	4.63
3M Libor	5.69	5.46	5.46	5.04	4.54
US Govt. 10Y	4.57	4.00	3.70	3.50	3.50
EURUSD	1.06	1.12	1.14	1.16	1.18

*Mid of target range

Note: If the forecasts have been changed from the previous week, the arrows indicate the direction.
Source: Market data provider, Erste Group Research

[1] By regulations we are obliged to issue the following statement: Forecasts are no reliable indicator of future performance.

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