25 July 2022

Research Germany

Zeitenwende

- **With the risk of a sudden Russian gas supply-stop still lurking in the background and a government that seems falling back into old fiscal habits, just at a time when the post-pandemic consumption boost is fading, Germany's economy is in for challenging times. We revise down our growth outlook, while expecting inflation pressures to linger for longer due to higher energy prices.**
- **To kickstart its growth prospects, Germany needs a *Zeitenwende* (paradigm shift) beyond foreign and security policy in our view. Accelerated investment spending on infrastructure, digitalisation and the green transition provide a silver lining, but until Europe's energy crisis is resolved, Germany is unlikely to return as the euro area's economic powerhouse anytime soon.**
- **A complete Russian gas cut-off would result in a recession lasting for several quarters, accompanied by rising unemployment and prolonged high inflation in our view. Government support could cushion the blow, however, ultimately the severity of the ensuing recession would depend on the duration of rationing and success in energy saving measures by consumers and firms.**

A perfect storm is brewing

We previously expected that a combination of strong order books, easing supply chain stress, pent-up consumer services demand and stepped-up investment spending would keep the German economy afloat during H2 22. However, the outlook for Germany's economy is clouding fast, as the three pillars of its old economic success model – industry, globalisation and cheap energy imports – have become its Achilles' heel.

The manufacturing sector is facing the perfect storm of protracted supply chain frictions, growing demand uncertainty, higher input costs and the risk of a Russian gas cut-off lingering in the background. Germany's manufacturing weakness is not a new feature, as industrial production has more or less flat-lined since the outbreak of the pandemic in 2020. Until recently this has mainly been a reflection of supply chain constraints (especially in the important car industry). However, recent business surveys point to waning demand for German goods, as inflows of new orders showed a deepening decline during July. Not only energy worries are weighing on the manufacturing outlook, as dry weather has again brought water levels in the Rhine – an important transport hub – to dangerously low levels.

Cracks in domestic demand have started to appear, as the post-lockdown boost to services is levelling off amid elevated inflation and an uncertain economic outlook. Consumer confidence has plunged deep into recessionary territory and although retail sales suggest that households have not curtailed their consumption by nearly as much, a downtrend is clearly visible in real spending (i.e. adjusted for inflation). Overall, high frequency data suggest that the growth momentum stagnated at the end of Q2 and forward looking indicators point to a clear risk of outright GDP declines in H2 22. With the risk of a sudden Russian gas supply-stop still lurking in the background and a government that seems falling back into old fiscal habits, just at a time when the post-pandemic consumption boost is fading, Germany's economy is in for challenging times in our view.

Danske economic projections

GDP	2022		2023	
Germany	1.0% (1.4%)	↘	0.0% (1.8%)	↘
Euro area	2.4% (2.8%)	↘	0.3% (1.8%)	↘
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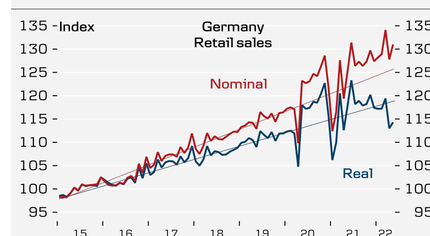
Parenthesis are the previous Danske projections (from May 2022)

Source: Eurostat, Macrobond Financial, Danske Bank

Manufacturing output has been flat-lining and new orders declining

Source: Destatis, Macrobond Financial, Danske Bank

Real spending is trending down as inflation has leaped



Source: Bundesbank, Destatis, Macrobond Financial, Danske Bank

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Looming energy crisis adds to headwinds

Concerns about a looming energy crisis have been rising, since Russia curtailed gas supply via the North Stream 1 pipeline due to spurious reasons. Helped by a benign winter, consumer energy savings and more LNG purchases, Germany's gas storage level is currently ca. 65%, in line with the seasonal average. However, should Russia continue to supply only 40% of previous volumes, refilling gas reserves to the 95% government target by November will be a challenge, leaving the risk of eventual energy rationing (read more in *Research - A full-on gas crunch would bring Europe to its knees*, 20 July).

In response, the government has raised its gas risk level to the second-highest 'alarm' phase in June. In addition to an appeal to citizens to conserve energy, the government plan foresees some coal-fired power plants to be reactivated to allow more natural gas to flow into storage (in 2021, 15.4% of electricity was generated from natural gas vs. 28.1% from coal and lignite). A new gas auctioning system for industry is also in the making, where industrial customers will be asked at what level of compensation they would be willing to give up all or part of their natural gas purchases. The government is also in bailout talks with Uniper, the country's largest buyer of Russian gas, which is struggling to fulfil delivery contracts amid the price surge and is in need of a EUR 9bn capital injection.

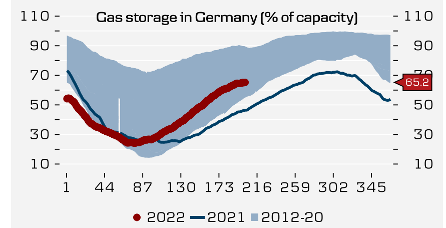
German consumers will likely continue to face further energy price increases in the coming months. Natural gas futures prices are up 100% since June (see also *Research - Restrictions of gas use moving closer in Europe*, 1 July) and the German trade balance fell to the lowest level since 1992, as energy import costs surged. Should natural gas prices stabilize at current prices, Germany's gas bill would climb to EUR 175bn, up from EUR 15bn before the Ukraine crisis (an increase of 4% of GDP). So far, the government refrained from activating the so-called pricing adjustment mechanism that would allow energy companies to pass on cost increases to consumers and businesses more quickly, but this seems more a question of time.

We think the setback in German inflation will prove temporary and expire with the energy relief measures in September. CPI inflation eased from 7.9% to 7.6% in June, but in the absence of the fuel tax rebate and 9 EUR/month subsidised public transport ticket, headline inflation would have been 1pp higher. Food price inflation remains a strong pro-inflationary force in the coming months (see also *Euro inflation notes - Food for thought*, 1 July). Despite the recent decline in commodity prices and freight rates, cost-push pressures on goods prices will keep core inflation elevated well into 2023 in our view.

The bright spot of the economy remains the labour market. Employment continues to reach new record highs and although the unemployment rate edged up marginally from 5.0% to 5.3% in June, this was due to an increase in the labour force from Ukrainian refugees. Business surveys suggest the hiring pace has slowed of late, but that might be as much a reflection of lack of labour supply as weaning labour demand. German industry has become increasingly vocal about their *need for qualified workers* and labour shortages at airports and restaurants have triggered government plans to enlist temporary workers from Turkey.

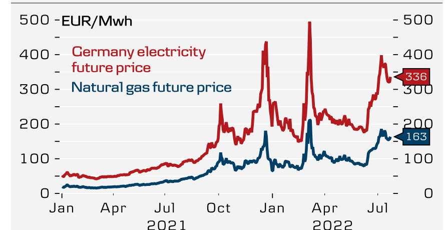
Adverse demographics remains one of the biggest long-term challenge for the German economy, as the workforce is set to shrink by more than *five million people* by the end of this decade. The influx of some 700,000 *Ukrainian refugees* could help ease the tightness in the German labour market. But Germany's *success in integrating refugees* in to the work force is mixed and insufficient language skills, a lack of childcare facilities and problems with the recognition of qualifications can all present obstacles.

Gas storage only 65% full



Source: GIE, Macrbond Financial, Danske Bank

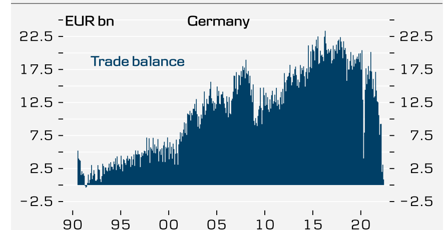
Gas and electricity prices have risen sharply



Note: Past performance is not a reliable indicator of current or future results.

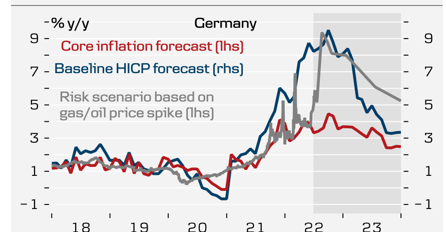
Source: Bloomberg, Macrobond Financial, Danske Bank

Surging energy import costs weigh on trade balance



Source: Bundesbank, Macrobond Financial, Danske Bank

High inflation lingering in 2023



Note: Past performance is not a reliable indicator of current or future results. Risk scenario sees gas prices spike to 300 EUR/Mwh and oil prices to 150 USD/bbl after Russian gas cut-off.

Source: Bloomberg, Eurostat, Macrobond Financial, Danske Bank

The tight labour market combined with rising consumer inflation expectations, has led to noticeable uptick in negotiated wage growth, although this is mainly due to one-off payments agreed in previous wage rounds. That said, unions have started to adjust pay demand upwards. The IG Metall negotiations for the metal and electro industry (affecting 3.9mio workers) kicking off in September will be the most important wage round this year. With the union demanding an 8% pay rise and benefiting from stronger bargaining power, we think the final agreement could land somewhere between 4-4.5% for 2023. With wage growth unlikely to return to the subdued pre-crisis levels (see also *Euro inflation notes - The wage conundrum*, 1 April), inflation pressures will subside only gradually in 2023, increasing the stagflationary risks for the economy.

Tensions within Germany's 'traffic light' coalition are rising about how to deal with the energy crisis. While Social Democrats and Greens are calling for further targeted consumer relief measures such as VAT cuts, liberal Finance Minister Lindner ruled out further support measures before 2023, citing budgetary constraints. In line with the 'debt brake', his 2023 budget plan foresees a 10% cut in spending compared to 2022, and only limited net borrowing of EUR 17.2bn (compared to nearly EUR 140bn in 2022). That said, *media reports* suggest that there is a silent agreement among cabinet members that the government will not be able to stick to its fiscal plans if Russia completely stops the gas supply. With budgetary demands piling up, we remain sceptic that Germany will be able to comply with the debt brake again next year. Another contentious issue remains the run-time extension of the remaining three nuclear power plants that are scheduled to go off the grid by the end of this year.

The Big Short: What if Russia closes the taps?

A complete Russian gas shut-off would have devastating consequences for the German economy. A combination of existing storage, consumer energy savings, alternative pipeline supplies from Norway and the Netherlands, and increased LNG imports could likely keep the economy afloat over summer and autumn. However, any delays in connecting new floating LNG terminals, a cold spell or increased demand from other European countries – Germany is also an important gas re-exporter – could lead to a shortfall in gas supply next winter.

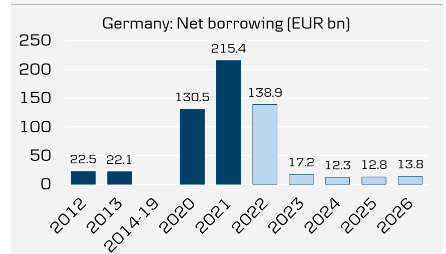
Industry (37%) and households (31%) account for more than two-thirds of gas usage, while only some 12% is used for electricity generation. According to *BDEW* the potential for energy substitution from gas remains very limited at 8% for the industrial sector (19% if including households, trade and services). In a worst case scenario, active gas rationing might be needed at some stage in late 2022/early 2023, with the Federal Network Agency determining supply for different sectors. According to the government's *'Gas Emergency Plan'*, protected customer groups such as households, essential social services and district heating systems would be the last to experience rationing, while 'non-essential' gas-reliant sectors, like the chemical industry, will be the first ones to see their supply cut.

We think a Russian gas supply stop would result in a recession lasting for several quarters, accompanied by rising unemployment. However, gauging the economic consequences of such drastic intervention is a difficult exercise. Many firms would likely have to cut back production and even those customers still supplied, will face skyrocketing prices. Gas intensive industries like chemicals, metals and glass face the biggest hurdles in maintaining their operations. While the petro-chemical industry accounts only for about 1.5% of gross value added and 6.8% of manufacturing output, several other industries - such as agriculture and food, cosmetics/hygiene, pharmaceuticals, automotive, construction, packaging and electronics - use raw materials produced from hydrocarbon molecules and would ultimately also be affected by supply shortages.

Negotiated wages trending higher

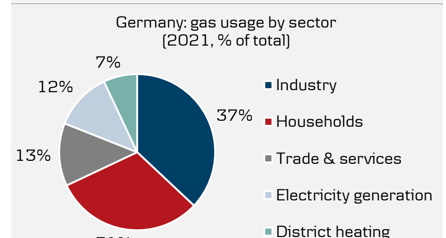
Source: Bundesbank, Macrobond Financial, Danske Bank

Complying with the 'debt brake' in 2023 will be difficult



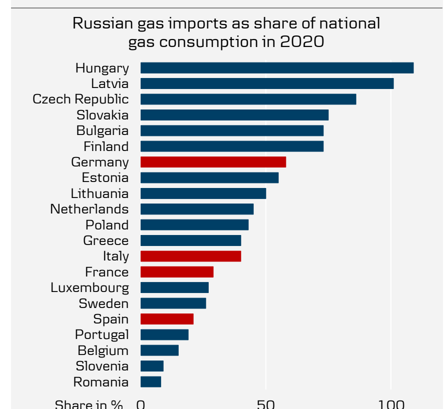
Source: Bundesfinanzministerium, Danske Bank

Industry and households account for more than two-thirds of gas usage



Source: BDEW, Danske Bank

Europe's Russian energy dependence comes back to haunt



Source: Ifo, Eurostat

As no historical precedent exists for such a wide-ranging energy crisis in Germany, model simulations have to be employed to estimate the potential economic effects. Using the methodology of *Bachmann et al. (2022)*, the *German Council of Economic Experts* estimates that in case of a Russian gas supply stop, German GDP could decline by roughly 2%, with most of the adverse effects materializing in 2023. Similar effects are found in a simulation from the leading *German think tanks*, but taking into account adverse spill over effects to supply chains, labour markets, confidence and financial conditions, GDP declines of 3-5% as found by *IMF* and *Bundesbank* could be possible in our view.

The collapse in economic activity will be accompanied by pro-longed high inflation. As part of stage three of the gas emergency plan, the government will likely also trigger Section 24 of the Energy Security Act (*Preisanpassungsklausel*), which allows energy providers affected by a reduction in gas imports to adjust customer prices to an 'appropriate' level (i.e. the replacement cost). This would again lead to significant consumer gas price increases, as only a fraction has been passed on so far. Overall, we see upside risks to German inflation of 2-3% in this scenario.

Government support for particularly hard-hit sectors and low-income households could cushion the blow. However, ultimately the severity of the ensuing recession would depend on the duration of rationing and success in energy saving measures by consumers and firms. Turning down the heating by 1-2°C in residential and commercial buildings across Europe could cut dependence on Russian gas by almost 10%, according to *Bruegel*. Lowered speed limits on roads in an effort to save fuel as well as shortened working weeks or increased use of home office could also be alternatives.

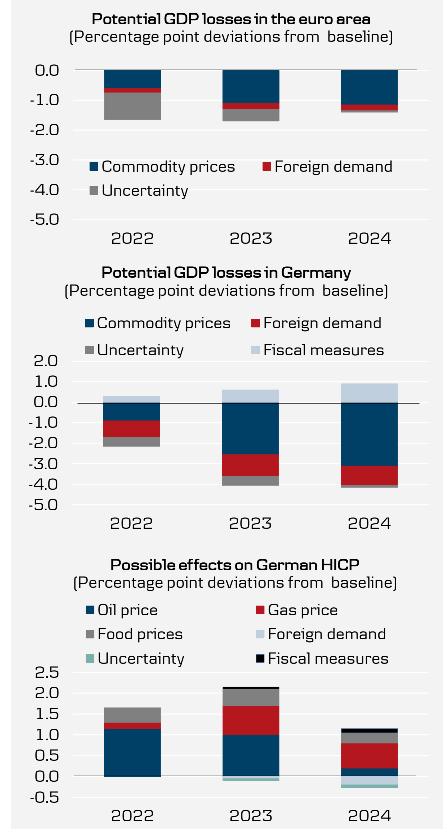
A challenge or opportunity?

Even if an immediate Russian gas cut-off has for now been avoided, the outlook for the German economy is clouding and we think a technical recession will be difficult to avoid. Persistently high inflation and weaker foreign demand are weighing on consumption and exports. Ongoing ECB hikes and tighter financial conditions will weigh on confidence and investments. Consequently, we revise down the outlook for GDP growth, while expecting inflation pressures to linger for longer due to higher energy prices (see table for details).

We think the German recession will also have adverse spill-overs to other euro area countries. Italy relies on Russian energy to a sizable extend and fiscal space for energy relief measures is limited. Following the collapse of Mario Draghi's unity government, implementing structural reforms will only become more difficult (*Flash comment - Italy is falling back into old habits*, 20 July). France and Spain are more insulated from energy shortages, due to alternative supplies from nuclear energy and LNG terminals/pipelines from North Africa (see *IMF*). However, also here the economic momentum has slowed and political risks are lingering in the background.

Until Europe's energy crisis is resolved, the growth outlook remains lacklustre. To maintain global competitiveness and kickstart its growth prospects, Germany needs a *Zeitenwende* (paradigm shift) beyond foreign and security policy. With globalisation slowing – or turning into 'friendshoring'– the economy has to adjust to a world, where services grow in importance relative to industrial exports. Stepped up investments on infrastructure, digitalisation and the green transition provide a silver lining for the growth outlook, but will also require an easing up of global supply bottlenecks and clearing of bureaucratic hurdles. In our view, Europe can, and eventually will, end its reliance on Russian energy, but the transition will not be without pain and take time. In the meantime, Germany is unlikely to return as the euro area's economic powerhouse anytime soon.

Pro-longed recession and higher inflation in case of Russian gas stop



Source: Bundesbank simulations

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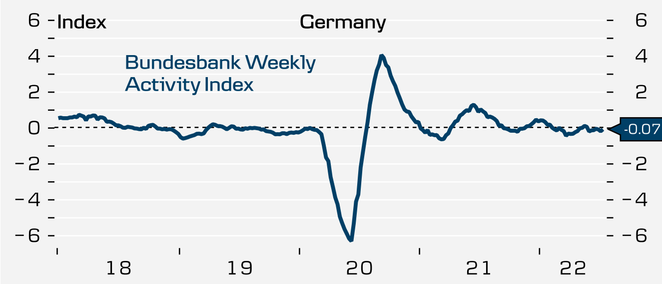
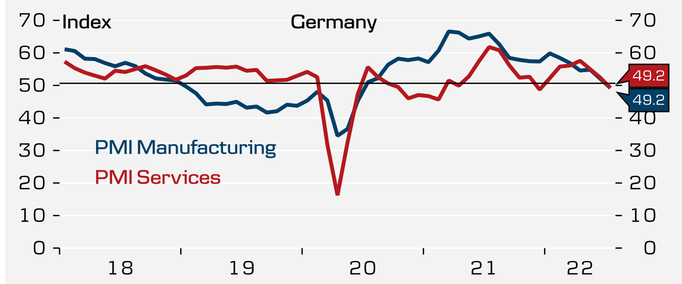
Growth momentum is stagnating...



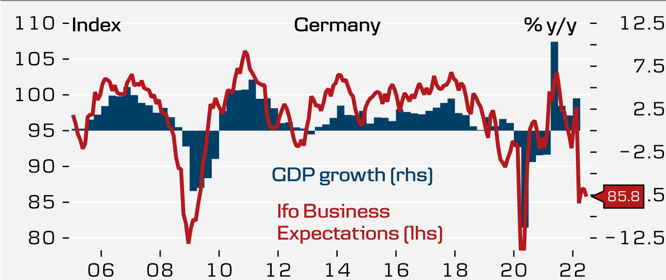
Source: Bundesbank, Destatis, Macrobond Financial, Danske Bank

... in both manufacturing and services



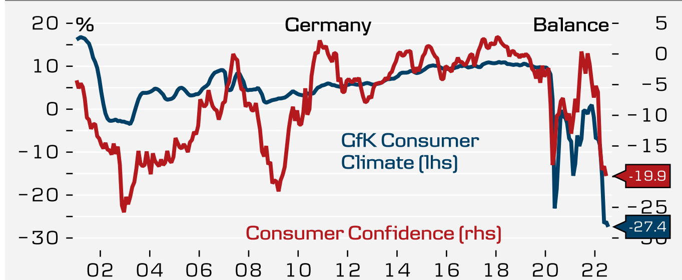
Source: Markit, Macrobond Financial, Danske Bank

Ifo expectations signal recession ahead



Source: Destatis, Ifo, Macrobond Financial, Danske Bank

Consumer confidence also in recessionary territory

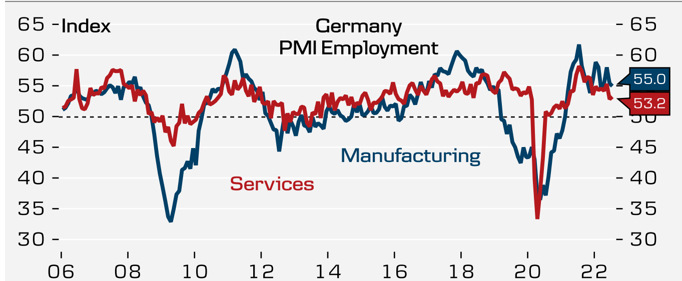


Source: Gfk, EU Commission, Macrobond Financial, Danske Bank

Labour market remains resilient...

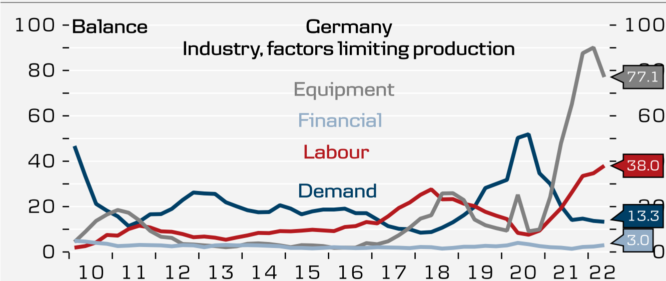
Source: Ifo, Macrobond Financial, Danske Bank

... although hiring pace has slowed



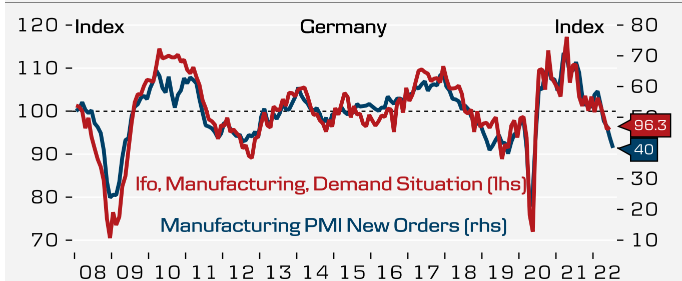
Source: Markit, Macrobond Financial, Danske Bank

Material shortages remain widespread



Source: EU Commission, Macrobond Financial, Danske Bank

Demand is weakening



Source: Markit, Ifo, Macrobond Financial, Danske Bank

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Aila Mihr, Senior Analyst.

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Ad-hoc

Date of first publication

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