Recovery in Germany – state of play

Dr. Ralph Solveen
Tel: +49 69 136 22322

In Q2, the German economy is likely to have grown strongly, and a plus of a similar magnitude is expected for Q3. In the coming winter, however, new restrictions due to significantly higher infection figures could slow down the economy again. However, a renewed decline in GDP should be prevented by the manufacturing sector gradually overcoming its supply chain problems.

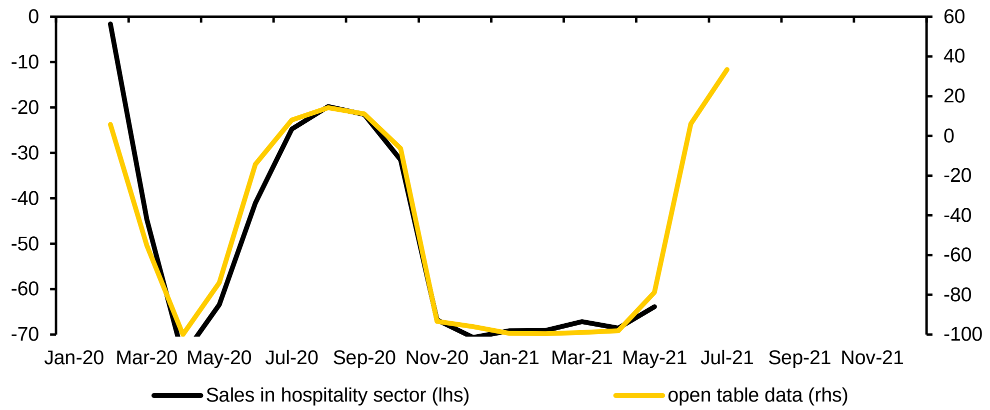
Strong growth in Q2 ...

Next week, the Federal Statistical Office will publish its first estimate for Q2 GDP. The question is not whether the economy has recovered from the setback in winter, but how strong this recovery has been. We expect a plus of 2.5% compared to the previous quarter, whereby the margin of uncertainty in this forecast – as always since the beginning of the pandemic – is considerably larger than in normal times.

... is underestimating dynamics of the recovery

One thing is clear, however: the figure reported next Friday will clearly underestimate the pace of the recovery. This is because in April and to some extent also in May, the restrictions enacted to combat the third wave of infection ("federal emergency brake") were still in force. For example, data from the platform open table, which has shown a close correlation with turnover in the hospitality sector since the beginning of the pandemic, show that reservations at restaurants affiliated to this network only increased strongly in June (Chart 1).

Chart 1 - Strong recovery of hospitality sector in June
Real sales in the hospitality sector and number of seated dinners on the open table network, change on respective month in 2019 in percent



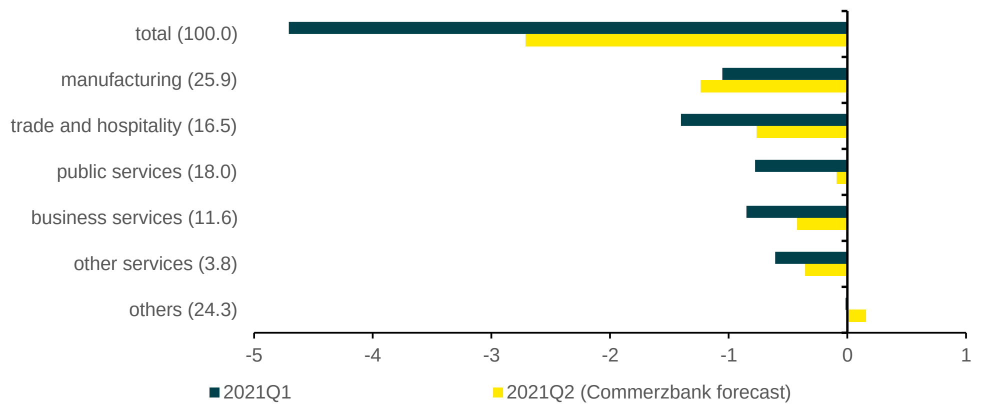
Source: Federal Statistical Office, open table, Commerzbank Research

Services benefit from the end of the lockdown

Other service sectors are also likely to have benefited from the lower infection figures and the resulting gradual easing of the Corona restrictions. For this reason, the strong increase in GDP in Q2 is likely to have been largely driven by sectors that otherwise play only a subordinate role for the economic cycle. In addition to the hotel and restaurant industry, public services (e.g. kindergardens, schools, public administration) in particular should be mentioned here, which had declined significantly in the winter due to many facilities being completely or partially closed. But value added in business services and "other services", which include cultural and sporting events, is also likely to have increased significantly.

However, it is also true for these sectors that in most cases the loosening of restrictions only began in the course of May or – e.g. in the case of events with many visitors – restrictions were largely maintained in Q2. Thus they are likely to have contributed significantly to the fact that in Q2 the gross value added of the German economy as a whole was probably still more than 2½% lower on average than before the outbreak of the pandemic (Chart 2).

Chart 2 - Services recovered in Q2
Real gross value added, gap to pre-crisis level (2019 Q4) and contribution of sectors to this gap, in percent or percentage points; in parentheses: Share in gross value added



Source: Federal statistical office, Commerzbank Research

Strong growth also in Q3, ...

According to the open table figures, economic activity in the hospitality sector continued to rise in July. The same is likely to be true for the other service sectors, especially as there has been further easing in recent weeks, particularly for large events. So even if the recovery were not to continue in August and September, real GDP will probably increase at least as much in Q3 as in Q2 and thus will come close to its pre-crisis level.

... driven by private consumption

As in Q2, private consumption in particular should drive the recovery. **This is because households will reduce their savings ratio, which has been unusually high since spring 2020, back to its normal level. In addition, they are likely to spend some of the additional savings.**

At the same time, the consumption of goods, which increased significantly during the crisis, could even decline again. This is because many households have recently put some of the money they would otherwise have spent on services into the purchase of goods. For example, real retail sales were above their pre-crisis level for much of the past twelve months. Here, too, there is likely to be a normalization in the coming months, i.e. sales are likely to fall again in at least some areas of the retail sector.

Risk factor delta variant

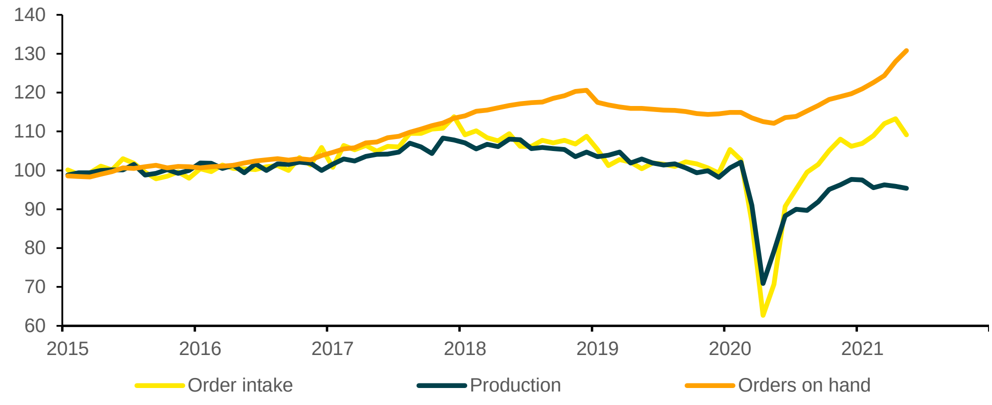
The biggest risk factor for the coming months is without question the further course of the pandemic. After all, infection figures are rising again worldwide. In view of the progress made with vaccinations, however, the retail and hospitality sectors in Germany, as in most advanced economies, are unlikely to be largely closed again. **The delta variant probably leads to less severe courses of disease in younger people and those who have been fully vaccinated, which would put less strain on hospitals than in earlier waves.** That is why the government apparently now wants to base decisions on possible restrictions not only on incidence but on a broader range of indicators.

However, in the winter at the latest, new restrictions are to be expected in the case of significantly higher infection figures, especially at large events. In addition, many people will probably behave more cautiously even without bans. This is likely to put a noticeable strain on the economy again, but is unlikely to cause GDP to fall again in Q4 2021 or in Q1 2022.

Manufacturing to prevent renewed GDP decline in winter ...

This is all the more true as the manufacturing sector is likely to pick up steam over the further course of the year once the various bottlenecks are overcome. Since the beginning of the year, production has been falling despite very lively demand (Chart 3), so that manufacturing may even have slowed down the economic recovery in the second quarter. The decisive factor here is **problems in the supply chains**, partly due to surprisingly strong demand for intermediate products, but partly also to interruptions in production and transport.

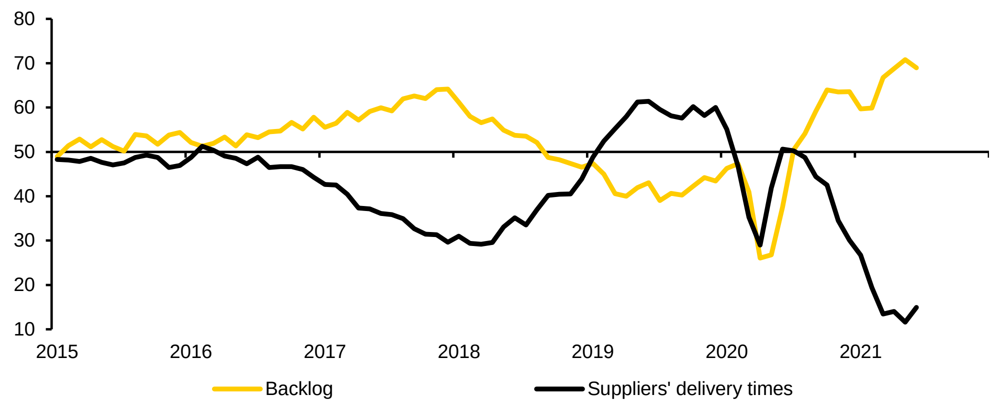
Chart 3 - Supply chain problems a brake for manufacturing
Manufacturing, volumes, 2015=100



Source: Federal statistical office, Commerzbank Research

So far there are no signs of a rapid easing of the situation. On the contrary, the corresponding sub-component of the manufacturing PMI remains close to its all-time low reached in May, so most companies are reporting ever longer delivery times for intermediate products (Chart 4). Consequently, industrial production is unlikely to increase much in Q3, despite the high order backlog that has accumulated in the meantime. We assume, however, that in winter the production losses caused in many cases by temporary negative effects such as extreme weather or accidents and the problems with transport will be overcome, so that companies can then gradually ramp up their production.

Chart 4 - Delivery times still rising
Subcomponents of PMI for German manufacturing



Source: Global Insight, Commerzbank Research

... despite weaker demand from China, ...

The fact that **demand from China is likely to weaken gradually in the course of the coming months due to the recent tightening of monetary policy** there is not likely to change this for the time being. This is because companies will first be busy working off their extensive order backlogs and reducing them to a normal level. In the further course of the coming year, however, the lower economic momentum in China is likely to slow down the manufacturing sector in Germany and other countries.

... but downside risks to growth forecasts

This emerging headwind from China and the consequences of a possible new wave of infection are thus unlikely to be enough to stop the recovery of the German economy. However, the downside risks to our current growth forecast of 4% this year and 4.5% next year have certainly increased. We will review these when the Q2 GDP figures are available next week.

FOMC preview – The Fed is not in a hurry

Bernd Weidensteiner
Tel: +49 69 136 24527

The Fed will not change course quickly at next week's meeting despite the high inflation rates, i.e. it will not yet give the promised signal to pre-announce the reduction of bond purchases. However, it is likely to push ahead with preparations and possibly present some ensuing considerations.

As Fed Chairman Powell explained in his recent appearance before Congress, the U.S. central bank believes it is still too far away from its targets to signal a gradual exit from its bond-buying program at this stage. At the meeting next week, the FOMC will therefore in all likelihood decide to continue bonds purchases in a volume of $120 billion per month for the time being - two-thirds of which will be earmarked for U.S. Treasury securities, the remainder for mortgage-backed bonds (MBS). Tapering requires "substantial further progress"; the Fed is likely to keep these key words of forward guidance unchanged in the statement to be released after the meeting. The federal funds target corridor will remain unchanged at 0.00% to 0.25%.

However, the jump in inflation in the spring and early summer has increased pressure on the Fed to consider adjusting its monetary policy. The inflation rate calculated on the basis of the consumer price index was 5.4% in June, the highest since 2008, and the core rate even marked a 30-year high of 4.5% (the Fed's preferred inflation rate based on the PCE deflator is a few tenths lower).

To be sure, the Fed admits that the strength of this move surprised it. However, it continues to believe that this surge in inflation is largely a consequence of the Corona crisis, as the reopening of large parts of the economy has created significant tensions. These influences would subside in the medium term. For 2022, the Fed therefore expects inflation to return to a more or less "normal" rate. The monetary policy recommendation in the event of such a development is to let the inflation hump pass and conduct monetary policy with a focus on medium to longer-term trends.

The bond market apparently shares the Fed's analysis. Longer-term inflation expectations are close to the Fed's 2% target, and U.S. Treasury yields also indicate no inflation risks (chart 1). Clearly, market participants do not expect the Fed to normalize policy too slowly.

As announced, the Fed is likely to discuss further tapering of bond purchases at next week's meeting. The Fed is likely to gradually publish more information on this. This serves not least to prepare the market sufficiently and to avoid a repeat of the "taper tantrum" of 2013, when initial indications by the Fed of an end to the bond purchases at that time caused market turmoil. We continue to assume that the Fed will give the signal for tapering in early fall and make the actual decision in the fourth quarter.

Chart 1 - The bond market does not fear inflation
Inflation expectations in 5 year for the following 5 years; 10-year Treasury yields. Weekly data in %.

Source: Global Insight, Commerzbank Research

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60327 Frankfurt	London, EC2P 2XY	NY 10281-1050		Causeway Bay
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