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Germany needs more than a plan

What to watch: Fed’s financial losses matter, Bank of England to hike some more, Allianz Pulse reveals German Angst

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What to watch

- **Fed’s financial losses matter** – an incentive to pivot in 2024 if inflation subsides
- **Bank of England**– wages, margins and economic activity all say ‘hike’
- **Allianz Pulse survey** – German Angst

In focus – Germany needs more than a plan

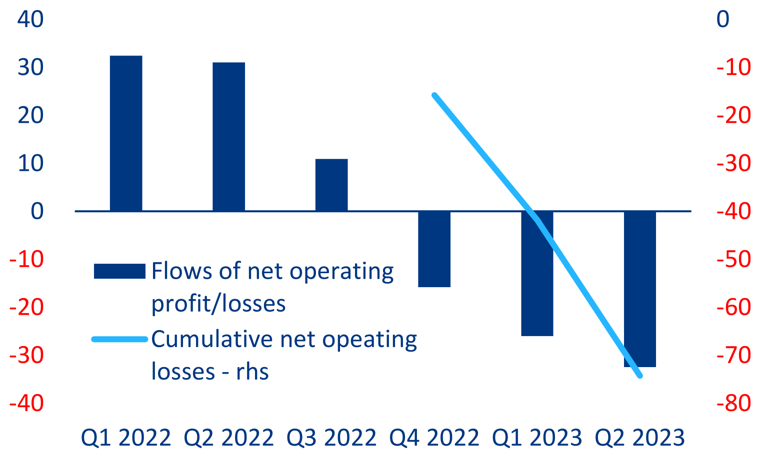
- **Germany is the only major economy that looks set to contract in 2023,** with headwinds such as slowing demand for its exports (particularly highly cyclical goods such as cars, machine tools and chemicals), lopsided global growth in services over goods, the industry slowdown in the US and China and an inventory correction.
- **Even if the government's economic plan is a step in the right direction, and will give growth a small boost, it is too small to restructure a EUR4trn economy.** Germany struggles with structural challenges, including labor shortages, high energy costs, elevated regulatory and tax burdens, slow digitization and policy uncertainty. To address these, Germany needs measures that strengthen its position as a place to innovate, invest and create high-value jobs.
- **While the government must create favorable conditions, companies also need to take countermeasures and actively implement the green and digital transition.** The keys to economic revival in Germany are a leaner state and productive investment instead of subsidies. Transformation requires collaboration between the government and the private sector.

Fed's financial losses matter – a strong incentive to pivot in 2024 if inflation subsides

With inflation and growth picking back up, we expect the Fed to deliver a final rate hike at its November meeting, after pausing in September. The CPI report released on Wednesday showed that inflation picked up to +3.7% y/y in August, a step up driven by higher gasoline prices. Furthermore, the pace of core price increases stepped up, to +0.3% m/m (after +0.2% in the two previous months). The further rise of the WTI price at the beginning of September should delay the pullback in consumer prices. Against this backdrop, the incoming economic data strengthen the expectation that Q3 GDP growth picked up pace through the summer months. Crucially, two powerful channels through which monetary policy is supposed influence aggregate demand – house prices and bank credit – have picked back up. If sustained, this could prolong above-trend growth and risk re-igniting underlying price pressures. Therefore, on balance, we think that the FOMC participants will press ahead with a 25bps rate hike in November after pausing (as widely expected) at next week's meeting. We acknowledge, however, the large uncertainty surrounding this call: in order to further their hawkish stance, FOMC participants could also emphasize their ''higher for longer'' narrative instead of hiking rates

Elevated interest rates are sending Fed's financial losses into the red. The potential medium-term implications of the Fed making increasingly large financial operating losses are drawing increasing attention. This is the first time since 1915 that the Fed is making losses. Over the past 20 years, it had remitted an average of USD63bn annually to the Treasury. But starting in Q4 2022, the Fed started to make increasingly large operating (as well as unrealized) losses (Figure 1) as the mismatch between what it earns on its assets and what its pays on its liabilities is widening. Indeed, the Fed owns a very large portfolio of securities (mortgage-backed securities and Treasuries) that yield a fixed interest rate. As all of this portfolio – currently about USD7.3trn – was purchased prior to the rise in interest rates in 2022, it yields a very low effective interest rate, a legacy of the pre-Covid era, which we estimate at around 2.27 %[1] in Q2 2023. Conversely, the Fed has to pay a variable, and sharply rising, interest rate on its liabilities (banks' reserve balances and repurchase agreements): we estimate the effective interest rate on its liabilities to have been around 5.03% in Q2 2023, up from only 0.81% in Q2 2022. The cumulative operating losses stood at USD74bn in Q2 2023 (Figure 1).

Figure 1: Fed's operating profit/losses, USD bn



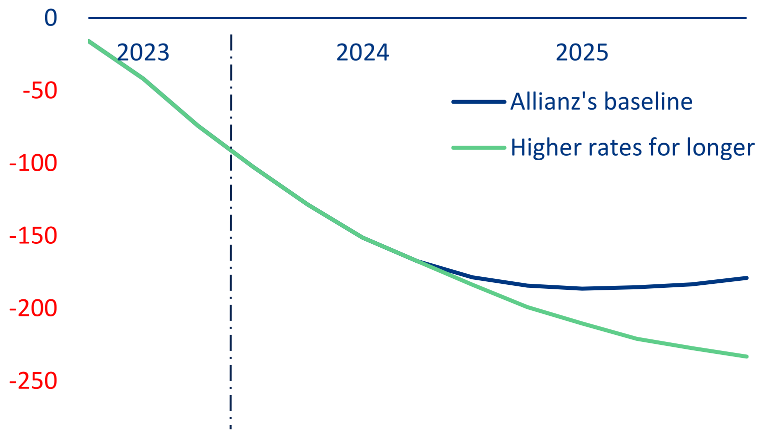
Sources: Fed, Refinitiv Datastream, Allianz Research

[1] *We include the loans made to the banks, which have a much higher interest rate than the Fed's holdings of Treasuries and MBS but are a small part of the aggregate Fed portfolio.*

Does it matter if a central bank makes losses? The Fed's cumulated USD74bn losses have already largely outstripped the central bank's USD42bn in capital. If the Fed was a commercial bank, it would be technically insolvent. But it does not really matter for a central bank to operate with negative equity: For instance, the central banks of Chile or Czechia have carried negative equity for a long time without being hampered in their ability to fulfill their objectives. A central bank's credibility depends first and foremost on its ability to meet its mandate and sometimes making losses ''can be the price to pay for achieving these aims'' (BIS, 2023).

Large, sustained losses can be problematic in the medium term as they may erode the public's trust in the institution. However, current times may be different in regard to the size of current and future losses the Fed (and other central banks) are and will be making. Under our assumptions that the policy rate settles at 4.25% (upper band) in end 2024 and 3.25% in end 2025, we estimate that the Fed's cumulative losses will keep increasing until the middle of 2025 to around USD186bn, or 2.8% of the Fed's assets, before slowly reducing thereafter as the Fed starts to make profits again (Figure 2). Such large losses could end up drawing the public's attention and start to erode its trust in the Fed's ability to fulfill its mandate, including that of maintaining price stability. Indeed, the Fed creates bank reserves to cover operating losses, that is central bank money, which are in principle inflationary. Large losses can thus go against the Fed's goal of price stability ultimately.

Figure 2: Forecast of the Fed's cumulative operating losses under different scenarios, USD bn



Sources: Fed, Refinitiv Datastream, Allianz Research

In the near term, the Fed is nudged to continue with quantitative tightening (QT), but in 2024 it will be incentivized to cut rates sooner rather than later. For now, as inflation is still elevated, it would be foolish for the Fed to start cutting rates. The most sensible way for the Fed to remain credible in its fight against high inflation while minimizing losses, is to continue with passive QT, i.e. letting its holdings of securities roll off as they mature. Passive QT allows the Fed to reduce the bank reserves as securities now need to be funded by the private sector. Lower bank reserves, in turn, mean lower interest to pay for the Fed. However, at the current pace (about USD100bn of securities being rolled off every month), the Fed may have to stop QT (and stabilize its balance sheet) by the end of Q2 2024. Indeed, we estimate that by then bank-reserves balances will have reached about 7% of GDP (Figure 3), a level below which volatility in the repo market may arise due to a shortage of liquidity, as the episode of September 2019 showed. Lowering interest rates will then become the only realistic option[2] for the Fed to stop making losses. If, as we expect, inflation does normalize in 2024 (approaching the 2% target), we think that keeping interest rates too high for the Fed may backfire. Under a scenario of ''higher rates for longer'' where the Fed does not pivot in 2024 (interest rates remain at about 5.5% by end 2024) and starts cutting rates slowly in 2025 (down to 4.5% by end 2025), we estimate that the US central bank would continue to accumulate losses (Figure 3). In other words, if inflation does subside next year, there is a strong argument for the Fed to pivot sooner rather than later, otherwise predictable large and accumulating losses could hurt its credibility to fulfill its objectives.

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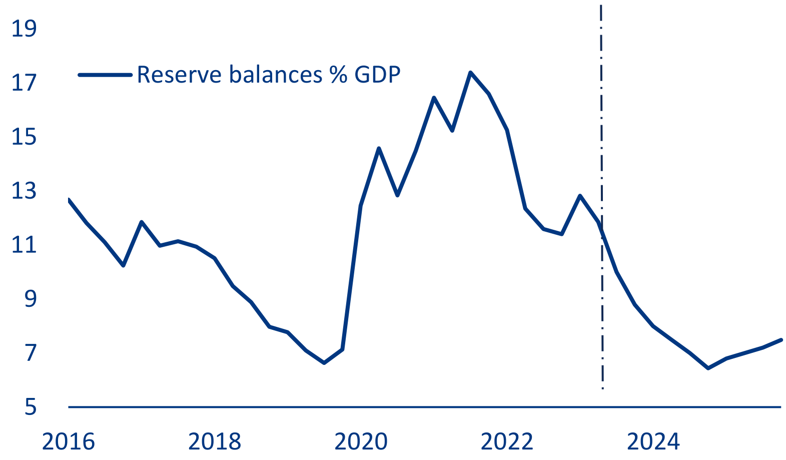
[2] *Another option, much less realistic, would be for the Fed to halt paying interest on bank reserves.*

Figure 3: Forecast of banks' reserve balances at the Fed, % GDP

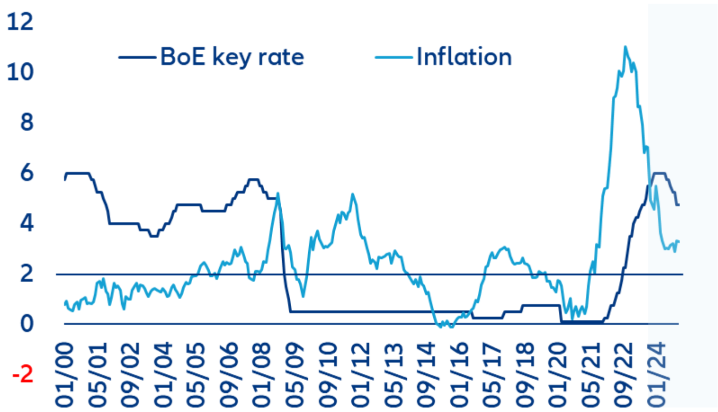


Sources: Fed, Refinitiv Datastream, Allianz Research. Note: we assume that the Fed stops QT in Q2 2024 and steadies its balance sheet thereafter at around USD6.7trn. We assume that after Q2 2024, liquidity from the repo facility flows gradually into reserve balances.

Bank of England – wages, margins and economic activity all say 'hike'

We expect one 25bps hike from the Bank of England at its next meeting on 21 September, which will increase its key interest rates to 5.5%, followed by a peak at 6% in December 2023. We expect rate cuts equivalent to a total of -125bps will only begin after H2 2024, which will push key rates to 4.75%. We believe inflation will remain high at slightly below 5% by December 2023, with continued elevated pressures from the services side. We do not expect inflation to fall below 3% in 2024 (Figure 4).

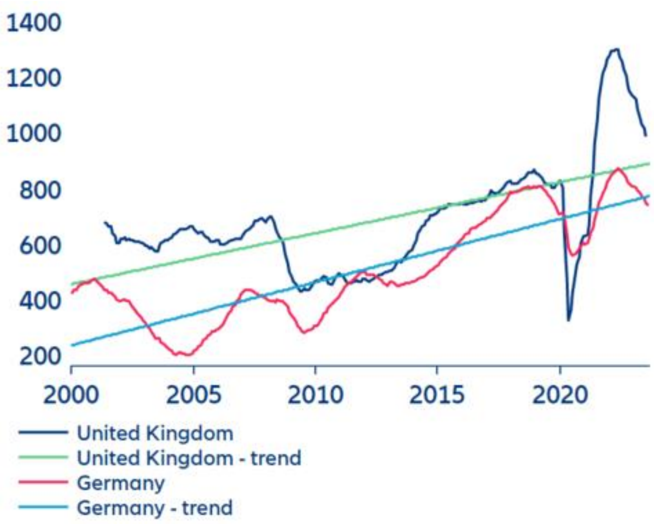
Figure 4: Bank of England key rates and inflation forecasts, %



Sources: Refinitiv, Allianz Research

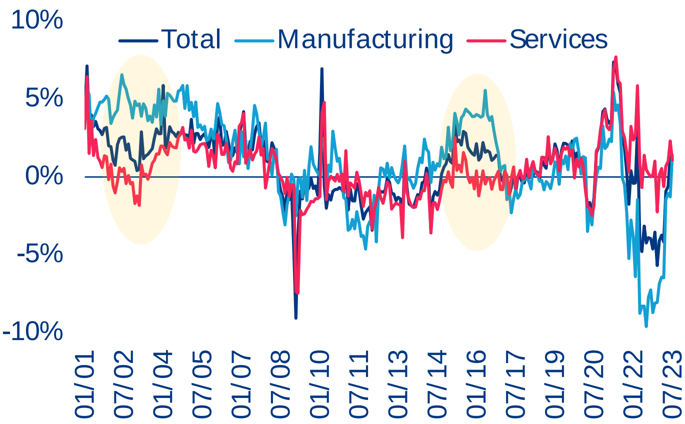
There are three reasons why the Bank of England's rates will peak at 6%. First, the tightness of the job market and the risk of a wage-price loop. The rebalancing of the UK labor market is ongoing but remains very slow. Job vacancies have fallen by -24% since their peak, but remain above trend (unlike in Germany, for example, Figure 5). The fall in employment picked up speed (-207K 3m change in July, three times more compared to June) and the unemployment rate remains very low (4.3% in July, +0.1pp from one month earlier). However, despite labor shortages cooling down, there seems to be no turning point in wage growth which still runs above 8% 3m y/y in services and manufacturing, and will probably stay well above the Bank of England's forecasts of 6.9% in September on average. Total real wage growth has been positive since June, and since April in the services sector (Figure 6). This is clearly a trend to monitor in the coming months as a wage-price loop could become a real risk if real wage growth is positive during three out of the next four quarters, i.e. until mid-2024[3]. The IMF has identified two such episodes in the past in the UK (2003, 2016), much less than in the US, which has seen six such episodes (1973, 1978, 1987, 1996, 2000 and 2017). Belgium and Germany, where wage growth is also currently very dynamic, have seen four (1999, 2005, 2010 and 2016) and three (1989, 2010 and 2017), respectively. As 2024 is a political year, we expect the minimum wage to be raised by at least another 7% after 9.7% this year, against inflation forecasts of 3.5% and 7% respectively, which means an acceleration in terms of the real wage growth. Total real wage growth is expected to reach a cumulative +3.9pps, compared to -3.1% in 2022 (Figure 7).

Figure 5: Job vacancies, thousands of people



Sources: Refinitiv, Allianz Research

Figure 6: Real wage growth by sector, y/y



Sources: Refinitiv, Allianz Research. Note: Past episodes of wage-price loops in the UK in yellow as three out of four quarters have registered an acceleration in prices and nominal wages.

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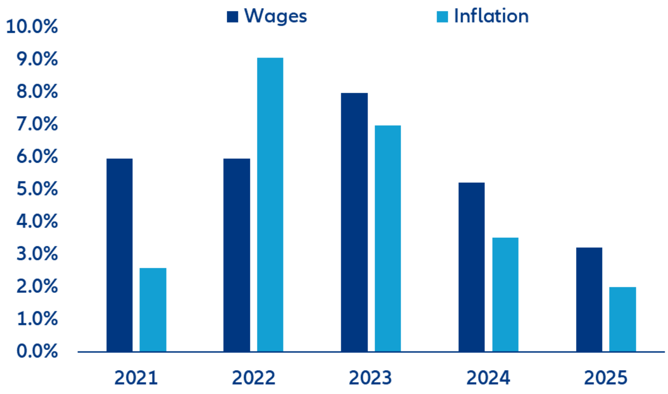
[3] As per the IMF definition in "Wage-Price Spirals: What is the Historical Evidence?", November 2022

Figure 7: Nominal wage and inflation forecasts, annual growth



Sources: Refinitiv, Allianz Research

Second, the corporate price outlook has stabilized at high levels and corporates margins are still growing. Companies' cost expectations have receded but they still remain higher than 2019 (Figure 8 a). This can be partly explained by higher labor costs. At the same time, expectations for selling prices are stable at high levels in B2B services, retail goods and services, while they adjusted downwards in the manufacturing sector to their lowest level since end-2021 (Figure 8 b). Corporates' EBITDA margins grew by +1pp of gross value added between Q2 2023 and Q2 2022, a sign that UK firms did not take the cost increases on their margins despite the acceleration in unit labor costs. This is clearly in contrast to the Eurozone and the US where margins have started to fall. Additionally, companies' cash buffers have been decreasing (-15% excess cash in July 2023 compared to end-2022).

Figure 8 a: Corporates' expectations on costs, net balance

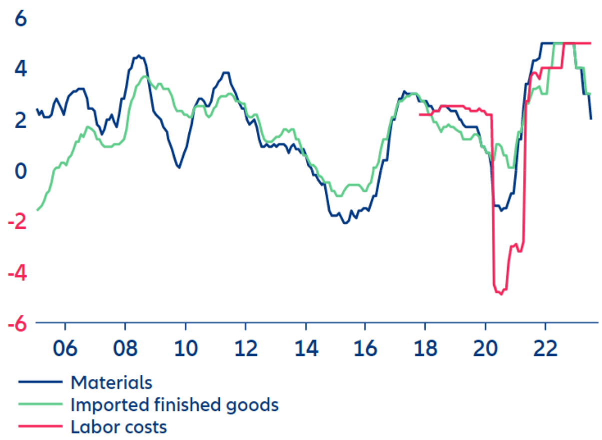
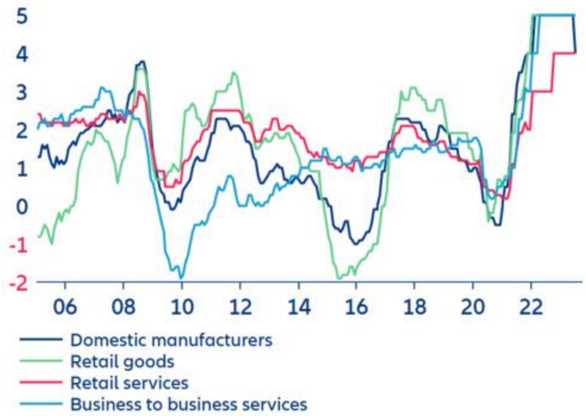


Figure 8 b: Corporates' expected selling prices, net balance



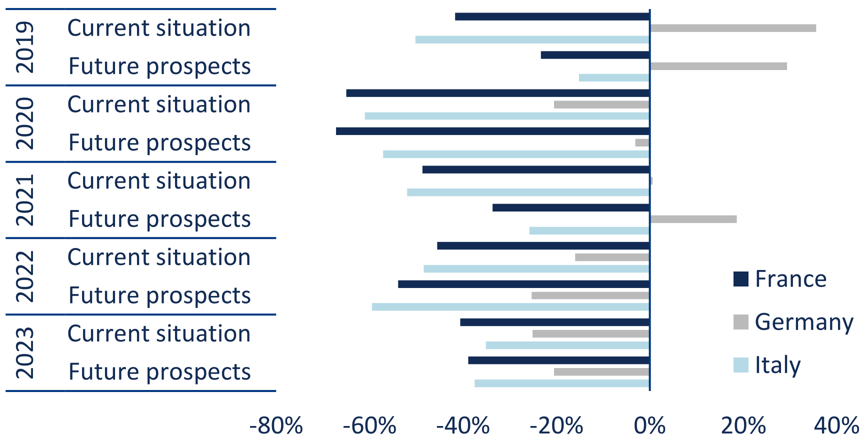
Sources: Bank of England, Refinitiv, Allianz Research

Finally, the economic outlook suggests lower recession risks and negative real interest rates until year-end. While the external environment has been a drag on activity in 2023, with exports decreasing by -3.1% y/y, domestic demand, and in particular the consumer, has been resilient. Despite the fall in GDP in July, we do not see a recessionary trend ongoing as the -0.5% m/m drop was probably driven by the number of days of strikes (almost twice as many working days lost) and unusually wet weather that pushed construction output into contraction. On one hand, UK households entered the tightening cycle with a large stock of savings, which currently stand at 4% of GDP. On the liabilities side, the bulk of outstanding mortgages is fixed for either two or five years. This is slowing the rise in effective average mortgage rates on the outstanding stock of debt and is making a difference of at least 200bps on interest rates on the flow and the stock of loans. The negative interest rates (-1.8% as of July) are expected to prevail until year-end, even though they already turned positive in the US back in April. This gives some additional time in terms of debt sustainability, and provides the Bank of England with some incentive to continue to increase interest rates to further cool down demand, notably in the services sector. While we expect the UK to avoid a recession, GDP growth will remain low at +0.3% and +0.6% in 2023 and 2024, respectively.

Allianz Pulse survey – German Angst

The results of our annual Allianz Pulse survey on the assessment of the economic situation reveal little that is surprising: the mood is bad, the outlook bleak. What is striking, however, is that the German participants in the survey are starting to pick up the pessimism of the French and Italian participants (Figure 9). While "German optimism" still stood out in 2019 and 2021, this year the negative voices clearly predominate: the net percentage stands at -25.1%. This means that German participants assess the current economic situation as even worse than in 2020, when the survey was conducted in the shadow of the first major Covid-19 wave, and in 2022, when the shock of the Russian war of aggression on Ukraine was still fresh. Significantly, this is not the case in either France or Italy, where survey participants are currently not quite as pessimistic (even if the absolute level is still lower than in Germany). It seems that German participants are only realizing with some delay that the geo-economic framework is currently shifting to Germany's disadvantage.

Figure 9: How do you assess the current situation and the future prospects of your country's economy? Net percentages

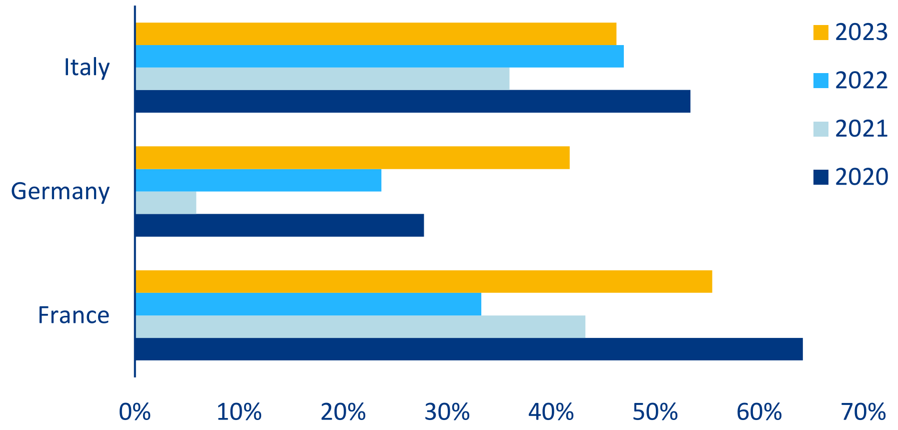


Source: Allianz Research. Net percentages are defined as the difference between the sum of the percentages of participants responding "very good" and "fairly good" and the sum of the percentages of participants responding "fairly bad" and "bad".

The differences between the generations are not very pronounced, even if the youngest participants (Gen-Z) are generally somewhat less anxious about the future. But even among them the pessimists clearly predominate: net percentage -22.5% vs -25.2% for the entire sample.

What also distinguishes this year's survey is the large discrepancy between the assessment of the general future outlook and that of the personal outlook. While in all years participants tended to see their own future as somewhat rosier than that of their respective countries, the gap was only as large as this year in pandemic times; in Germany, it reached an all-time high this year (Figure 10). The differences between the three countries are therefore no longer so pronounced. This also applies to the generational comparison. Although the "personal gap" is highest in the two younger generations (Gen-Z and Millennials) at around 50pps, it is also very high among the older participants at just under 30pps.

Figure 10: Personal future versus general future, net percentages



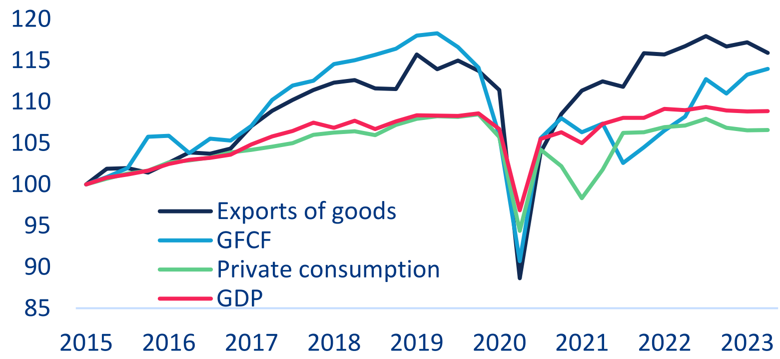
Source: Allianz Research. Net percentages are defined as the difference between the sum of the percentages of participants responding "very good" and "fairly good" with regard to personal future prospects and the sum of the percentages of participants responding "very good" and "fairly good" with regard to general future prospects.

The reason for this remarkable decoupling is probably the still robust labor market. As long as the fear of job losses remains subdued, the general misery can be ignored. This split assessment of the future is both an opportunity and a risk. If the personal mood remains positive, the feared downturn is likely to be shallow. On the other hand, if the confidence that it is always the "others" who are hit by economic hardship falters, there is the threat of a sudden rude awakening. A mild recession can then turn into years of stagnation. This would be a dangerous scenario not only economically but also politically.

In focus – Germany needs more than a plan

The erstwhile powerhouse of Europe has turned into the only major economy that looks set to contract in 2023. Germany has barely recovered to pre-pandemic levels (Figure 11) and the outlook for the second half of 2023 does not look any more encouraging. All major indicators signal a downturn as headwinds from slowing global demand and heavy exposure to the slowdowns in the US and China weigh on Germany's highly cyclical economy. We expect GDP to drop by -0.3% in 2023 (US: +2.2%, FR: +0.9%, Eurozone: +0.6%) but we do not expect the German recession to last beyond the coming winter. For 2024, we expect the German economy to return to an upswing backed by all major components of demand, with a slight recovery of +0.8% (US: +1.1%, FR: +0.7%, Eurozone: +1.0%) in GDP.

Figure 11: German GDP and contributions (Index 2015 = 100)



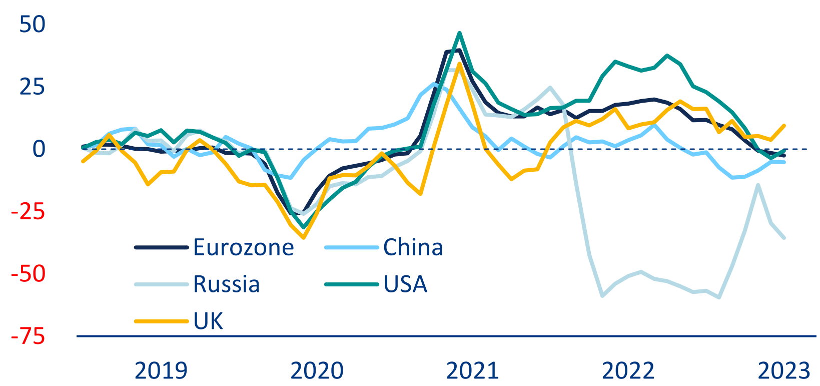
Sources: Refinitiv Datastream, Allianz Research

Slowing global demand and a more fragmented global economy are eating into German exports. In the first half of 2023, German exports rose by a total of +3.3% y/y to EUR797.8bn while goods worth a total of EUR699.1bn were imported into Germany. This was 4.3% less than in the first half of 2022. The trade balance is still not back to pre-pandemic levels and with global and especially Chinese demand set to remain lower for longer, the trade balance is unlikely to recover for some time. Overall, German businesses are more susceptible to the fluctuations of the global manufacturing cycle due to the specialization of companies in exporting highly cyclical goods such as cars, machine tools and chemicals. In the past, vertically integrated industrial value chains have proven to be an advantage in global competition and have been able to compensate for some cost disadvantages (i.e. wages, regulation, energy). But now global fragmentation and de-risking have brought an end to this.

Germany also currently faces lopsided global growth in services and goods. Consumers are eager to spend gains in income on services rather than on the kinds of goods that Germany produces. In contrast, countries such as the US, France or Spain are more services-oriented. In Germany, 18.5% of the value added in GDP comes from manufacturing (compared to 9.3% in France or 10.7% in the US), while 62.7% of value added in GDP stems from services (compared to 70.3% in France and 77.6% in the US). German services are mostly based on a vast industry-services network, efficient logistics and customer-specific after-sales services that are mostly connected to manufacturing and do not meet current consumer demand.

In addition, Germany is highly exposed to US manufacturing and the Chinese slowdown. US industrial output has fallen into recession and is expected to contract further in the second half of 2023. German exports have dropped by -11.8% y/y in the first half of 2023 (Figure 12). At the same time, the Chinese post-pandemic reopening has not resulted in stronger demand for imports. Instead, German exports to China fell by -7.9% y/y in the first half of 2023.

Figure 12: German exports to trade partners, 3-m moving averages y/y in %



Sources: Refinitiv Datastreams, Allianz Research

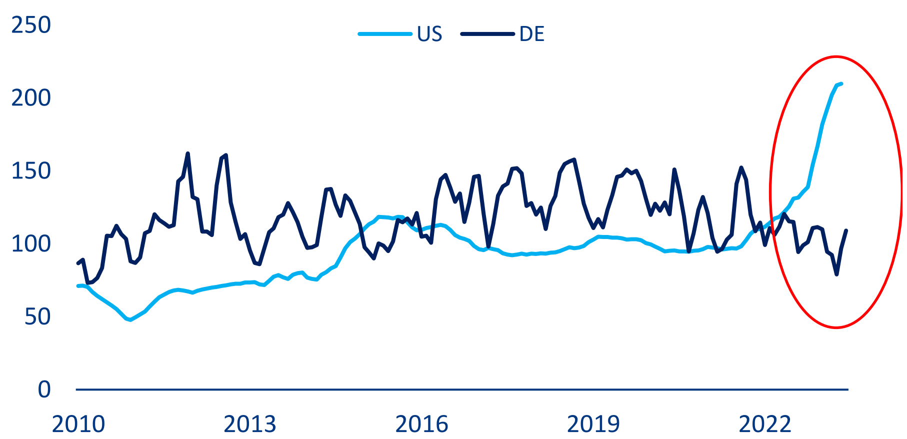
Finally, an inventory correction will cause a further fall in manufacturing output. After a more-than-usual increase in inventories when pandemic-related shortages ceased, retailers are now paring back their stocks of inputs and finished goods amid flagging demand. With its huge export-oriented manufacturing sector, Germany will again be hit harder than most other European economies.

Will the government's latest rescue plan save the day? Some of the cyclical issues are intertwined with more structural headwinds that hold Germany back. These include pervasive labor shortages, excessive energy costs partly caused by misguided energy policies in the past, high regulatory and tax burdens, slow digitization and policy uncertainty. Compared to the troubles of 1995-2004, however, Germany today enjoys record employment, high demand for labor and a rather comfortable fiscal position. That makes it much easier to adjust to shocks. Nevertheless, the current downturn may serve as a wake-up call. While growth-enhancing reforms were blocked until 2002 by the then center-left coalition, the current government shows less resistance and recently put forward a rescue plan. The 10-point economic plan tries to tackle the headwinds and to create stimulus for the economy. The Growth and Opportunity Act makes up the core and complements existing measures to provide tax support for companies and climate-friendly investments. These include an investment premium, tax-loss deduction, improved depreciation terms, a temporary reintroduction of declining-balance depreciation options for movable assets and residential buildings and strengthening tax incentives for research and development. They are expected to result in a tax cut of EUR7bn per year up to 2028. The expanded depreciation options provide a stimulus of EUR500mn specifically for housing construction.

While the plan is a step in the right direction, and will give growth a small boost, it is too small to restructure a EUR4trn economy. Even before announcing the current plan, the government attempted to create some stimulus for investments through industrial policy. But the problem is not a lack of funds, it is the nature of the administration itself. Germany currently has to pay the price of its partially misguided past energy- and managing-rather-than reforming policy choices. As net-zero targets are achieved and energy prices remain higher for longer, a loss of some of energy-intensive industries is inevitable. This will hurt as the chemical and metal industries are among the most research-intensive ones and produce more innovations on average than other industries. As they generate about 20% of industrial value add in Germany and employ about 16% of the industrial workforce, this will have a significant impact on prosperity.

Germany's transformation process is already in full swing. Companies have begun to leave Germany for locations with cheaper energy. Nevertheless, the German government has proposed an 80% electricity price subsidy for heavy industry (*Industriestrompreis*), which carries a EUR30bn price tag – though this is not yet decided. It has also drafted subsidy plans for clean production in heavy industry worth around EUR20bn and EUR20bn of subsidies have already been earmarked for chip production plants, of which EUR10bn alone will go to Intel. Yet, it remains to be seen whether this will be enough to drive private investments in Germany, the way investments associated with the Inflation Reduction Act contrary have pushed up new plant investments in the US (Figure 13).

Figure 13: New plant construction investments, 3-m moving average Index 2019 = 100

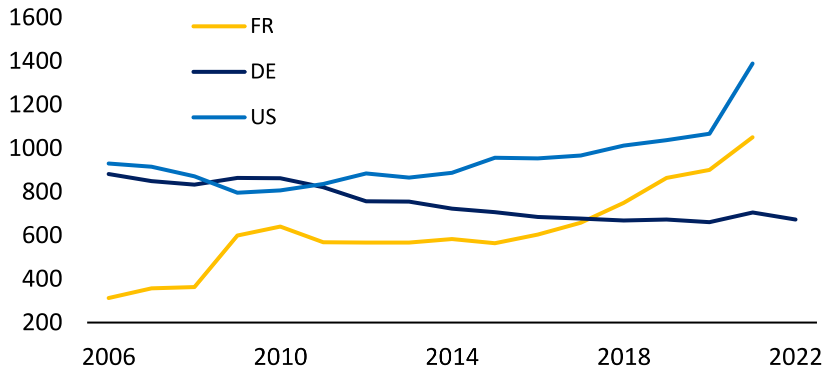


Sources: BEA, Destatis, Allianz Research. Note: US: total private construction spending price adjusted using the PPI for intermediate demand "materials and components for construction". Germany: Veranschlagte Baukosten, Baugenehmigungen Fabriken und Werkstattgebäude, price adjusted with Baupreisindex für gewerbliche Betriebsgebäude, Bauleistungen am Bauwerk.

Germany needs measures that strengthen it as a place to innovate, invest and create high-value jobs. On the positive side, Germany is still strong in patent applications and investments in research and development. But German expenditure has flatlined in recent years. Moreover, a country attractive to founders looks different: venture capital has dropped in recent years and the flatlining of new enterprises and start-ups might be another signal that the attractiveness of Germany as a business location is in decline (Figure 14). In the future, gains in value added will likely stem from sectors not among the traditional strengths of Germany, such as close contact personnel services, software, big data and entertainment. To succeed, Germany will need to make and keep its economy sufficiently flexible to cope with such shifts. Hence, it needs to get its policies right.

The Future Financing Act, which allocates EUR1bn annually, aims to facilitate start-up financing and going public while addressing capital market barriers. Additionally, the Promote the Future initiative plans to invest EUR20bn in education and research. However, the effectiveness of these initiatives remains uncertain due to the vague implementation plans.

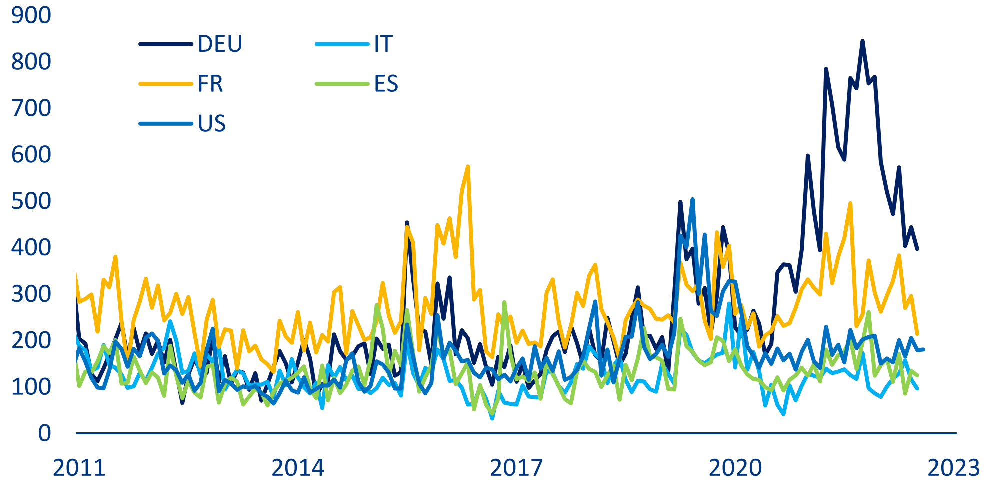
Figure 14: Number of new enterprises, in thousands



Source: OECD, Allianz Research

German companies need policy certainty to plan and invest accordingly. This includes clarity on the price for carbon and fossil-fuel energy. The Climate and Transformation Fund, with a budget of EUR211bn, provides a path forward. In 2024, EUR58bn will be allocated to building refurbishment, industry decarbonization, climate-neutral mobility, semiconductor production and the development of the hydrogen industry. Another EUR54bn has been allocated for infrastructure replacement, developing charging-station networks for electric cars, fiber optic lines for fast internet and the ramp up of climate-neutral hydrogen. Funding for these initiatives stems from a special fund financed by the European trade in CO2 certificates determined by national price systems. Overall, Germany requires lower energy prices, achievable through increased domestic energy production. However, the current lack of clarity in proposed green energy solutions, network expansion, power plant strategy and hydrogen acceleration law creates uncertainty for companies in their planning (Figure 15).

Figure 15: Policy uncertainty, in %



Source: Baker, Bloom, Davis (2016), Allianz Research

Germany also urgently needs to cut red tape and accelerate digitization to attract investments. Simplifying regulations, reducing bureaucracy and strengthening administrative capacity are crucial. The government must prioritize faster planning and approval procedures to facilitate economic investments. The current proposal addresses data access and use, pharma clinical trial regulations and the digitization of key administrative services. This is long overdue and essential, particularly in administration. But there are other missed opportunities from the past that Germany also needs to catch up on to address the backlog in digital services.

The skilled worker immigration act, which lowers barriers to skilled immigration, is a positive step to address the labor shortage. Education and research face significant challenges, including insufficient funding and personnel, hindering access to quality education and limiting women's participation in the workforce. Addressing these issues is crucial for Germany's long-term success in fostering innovation and entrepreneurship. However, the skilled worker immigration act would need to be complemented by tax and pension reforms to incentivize domestic labor supply alongside skilled immigration. Automation can help mitigate the skills gap and labor shortage by speeding up processes and utilizing scarce talent. The winning hand is a highly trained, engaged workforce working in concert with cutting-edge technology and automation. While automation can make jobs more inclusive and safer, it can also provide instant and on-demand training. Concerns about job displacement are countered by predictions that new technologies will create more jobs than they eliminate. For instance, the World Economic Forum estimates that by 2025, new technologies will create at least 12mn more jobs than they eliminate.

Expanding trade relations and securing raw material supply are crucial for Germany's green transformation. This provides a great opportunity to recreate Germany's business model in a sustainable manner, but significant investment efforts from both the public and private sectors are needed to shoulder the massive decarbonization task. Germany is at the heart of a promising EU green tech manufacturing base. No other G7 country – or China – exported more green goods than Germany as a share of GDP. The government needs to dare to achieve more green progress and push green technologies as they both support Germany's path to climate neutrality while benefiting the economy. But change is unavoidable for most companies and industries and the economy needs policies that focus on improving the framework conditions, securing necessary investments for an adequate supply of cheap, low carbon energy and promoting the research and development of new products and services with potential for value add.

Finally, German companies also need to take countermeasures themselves and be open to reforms. They should design work processes in a way that they can react quickly to shocks, and anticipate geopolitical changes and impeding decarbonization. The keys to economic revival in Germany are a leaner state and investment instead of subsidies. Transformation requires collaboration between the government and entrepreneurial action. The government must create favorable conditions, while companies must actively implement the green and digital transition.

These assessments are, as always, subject to the disclaimer provided below.