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What to watch: ECB holding tight, no quick fix for the German property sector and Argentina's catch-22

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Executive summary

This week, we look at three critical issues:

- **ECB on hold again.** At its next meeting on 7 March, we expect the ECB to keep the deposit rate unchanged at 4.0% for the fourth time in a row. As the pace of disinflation slows down and wage growth has reaccelerated, we maintain our forecast of only 50bps of cuts in the second half of 2024. Meanwhile, significant central bank losses add another strain on fiscal balances, serving as an additional incentive for the ECB to adhere to quantitative tightening (QT) despite forthcoming policy easing.

- **No quick fix for the German property sector.** While house prices have fallen sharply over the last two years, we expect a stabilization of the property sector in 2024. The construction sector is taking the hit from constrained demand and elevated construction costs (+23.3% from Q1 2021 to Q3 2023). Between January and November 2023, 2,800 construction companies filed for bankruptcy (+14.8% y/y). Beyond the real economy, our analysis also looks at the housing-banking doom loop which appears under control for now. However, social consequences need to be monitored closely. The government has proposed a comprehensive package to revitalize the sector, which contributes 6% of German GDP, but it could be too little, too late.

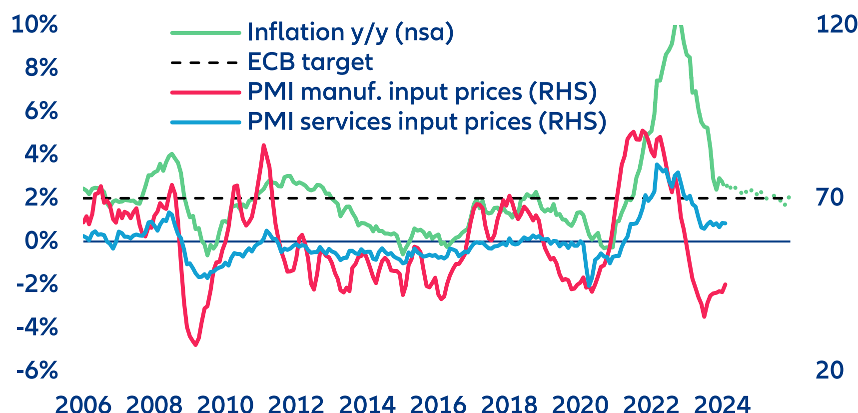
- **A catch-22 for Argentina.** The sharp devaluation of the peso and strong fiscal consolidation should weigh on Argentines' real income, pushing them down by nearly -10% in 2024, and strongly hitting consumption. We expect negative GDP growth of -2.5% in 2024, only offset by good agricultural output. Our expectations are for economic growth to recover to around +2% in 2025, driven by a strong J-curve effect on exports and a general improvement in the country's economic sentiment due to reforms that are (for now) welcome by the population in spite of the strong belt-tightening. But this is the catch: President Javier Milei's pivotal Omnibus Law was rejected by Congress, meaning that major reforms could be watered down.

ECB on hold again

The ECB will stay on hold again next week to avoid the risks of cutting too early. The ECB is expected to maintain the status quo at its next meeting on 7 March, holding the deposit rate at a historically high 4.0% for a fourth consecutive meeting (MLF: 4.75%, MRO: 4.5%). Last month, the consensus among the Governing Council was that the risk of cutting policy rates too early still outweighs that of cutting rates too late, according to the accounts. Data released since then have been on the strong side, with the composite Eurozone PMI increasing by one point to 48.9 (an eight-month high, albeit still in contractionary territory) while wage growth and core inflation re-accelerated in January. Therefore, there is no reason to believe that the rather hawkish mood will change by next week. February inflation data will be published on 01 March, which could still change current expectations in either direction. However, it is unlikely to trigger any action next week.

Staff estimates for inflation will be lowered but slower "last mile" disinflation will remain in focus as wage pressures continue. In January, Eurozone inflation only came down marginally to 2.8% y/y and 3.3% y/y in the core measure and thereby still significantly above target. More importantly, core inflation sequentially reaccelerated for a third month in a row to 0.3% m/m, which translates to an annualized rate of 4.9%. PMI subcomponents on input prices indicate that price pressures in the services sector remain high, given continued strength in wage growth (Figure 1). Although the ECB's measure of negotiated wages slightly decelerated to 4.5% y/y in Q4 2023, it remains uncomfortably high. The more frequent and up-to-date Indeed wage tracker even reaccelerated to 4.1% y/y in January, the highest print since July last year. In this context, ECB staff estimates for inflation in 2024 will likely be lowered in the forthcoming meeting as the last estimate in December was comparatively high at 2.7% (current consensus: 2.3%, Allianz: 2.4%). However, the downward revision is expected to be less pronounced than initially anticipated.

Figure 1: Eurozone inflation including Allianz forecast and PMI input prices



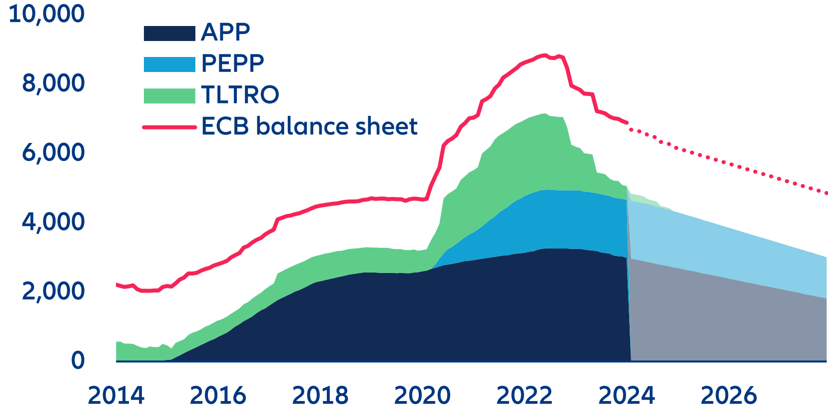
Sources: LSEG Datastream, S&P Global, Allianz Research

Quantitative tightening will continue as central bank losses start to bite fiscal income in the absence of future transfers. The ECB will proceed with quantitative tightening according to the announcement last December: a passive roll-off of bonds in the APP program at an average pace of around EUR25bn per month and an additional EUR7.5bn from the PEPP program starting in July. Last week, the Bundesbank and the ECB's annual financial statements showed large losses on their balance sheets, given the significant interest rate mismatch between assets and liabilities (Figure 3). Other central banks such as Banca d'Italia (BdI) and Banque de France (BdF) will release their reports in March, but a similar albeit less pronounced outcome is likely. The combined balance sheet of the Euro monetary system currently sits on close to EUR3.0tn of bonds with a coupon of marginally above 0% as they were largely bought during the low interest rate environment before June 2022 when QE stopped. On the liabilities side, the EMS has deposits by commercial banks amounting to more than EUR3.5trn which pay the deposit rate of 4.0% for now. This mismatch of currently annualized EUR120bn unsurprisingly hits the profits of central banks.[1] Of

[1] 120 billion is an approximation based on the assumption that the average, capital key weighted coupon rate on the EUR3.0trn bond holdings in the EMS is around 0.8% and the costs for the deposit rate of 4.0% on EUR3.5trn.

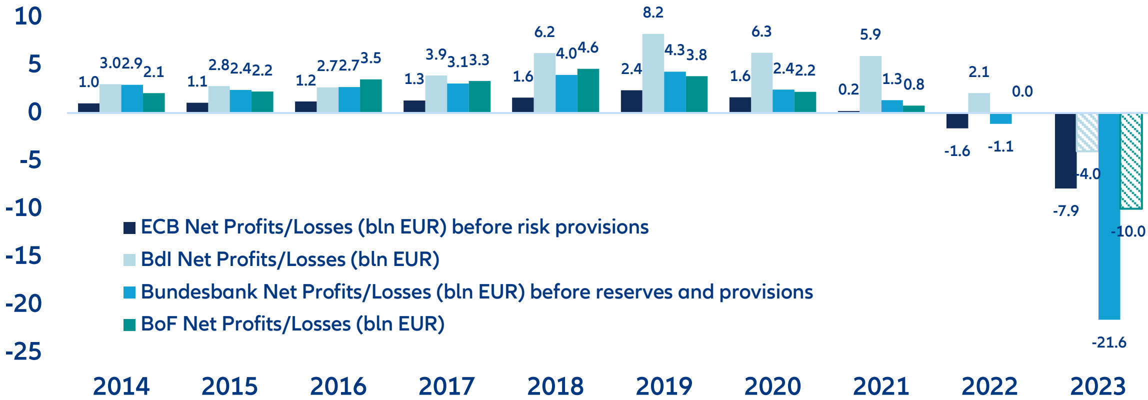
course, the ECB's core mandate is price stability and not profit generation. Nevertheless, as past profits equivalent to 0.2%-0.5% of GDP were transferred to governments, this income stream will stop for the next few years as central banks will need to replenish their risk provisions even after balance sheet losses stop. This results in a another less obvious second-round effect from monetary tightening ahead. The ECB will therefore be eager to reduce the balance sheet going forward and – without officially admitting this incentive – lowering the deposit rate at some point will also help here (Figure 2).

Figure 2: ECB balance sheet including Allianz forecast, EUR bn



Sources: LSEG Datastream, Allianz Research

Figure 3: Central bank profit and losses, EUR bn



Sources: ECB, Bundesbank, BdI, BdF, Allianz Research. Notes: 2023 BdI and BdF are estimates.

Going forward, we stick to our long-held call of two 25bps rate cuts in July and September as inflation gets closer to the ECB's target, and another 75bps next year. As growth is expected to rebound in the second half this year, the ECB will most likely pause after September and wait until the inflation target has been met on a sustainable basis (not expected before Q1 2025). This view is now increasingly shared by markets, which have significantly lowered the size of expected cumulative cuts in 2024 to 90bps from 160bps in December (Figure 4). However, uncertainty is currently very high, given the high dispersion of leading indicators. There remains the risk of financial turmoil triggered by a geopolitical event, an escalation in the commercial real estate market or simply a lagged effect of monetary tightening on investment that would trigger a much faster and more pronounced easing path by the ECB.

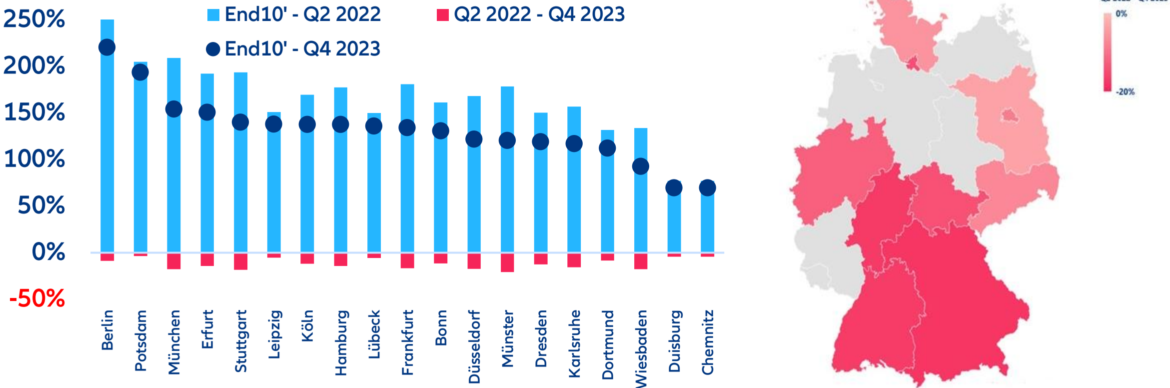
Figure 4: Market pricing for policy rate change in 2024

Sources: Bloomberg, Allianz Research

No quick fix for the German property sector

German house prices corrected strongly (down 10-15% from their peak in mid-2022) after a long period of growth. But we expect a stabilization in 2024 as supply constraints more than offset the fall in demand. The correction was significant yet uneven across different regions (Figure 5) and property sizes, and between new and existing homes. Yet, house prices are still 100-150% above what they were before the era of low interest rates. Going forward, as supply takes a hit, inflation and scarcity will push rental prices up. This combined with a relatively low unemployment rate and a gradual resurgence in economic activity should lead to a stabilization in house prices in 2024. However, this will not mean a return to the levels seen in the recent past as higher borrowing costs and tighter lending standards will still weigh on activity.

Figure 5: Cumulated house prices evolution by city since 2010

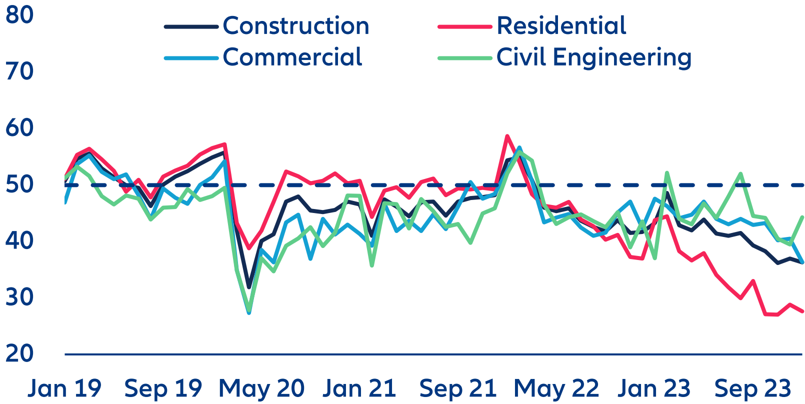


Sources: GREIX price indexes, Allianz Research. Regional colors are assigned as an average correction of the cities (lhs chart) in each territory. States for which there is no data in the lhs are in grey.

In this context, we see no respite for the construction sector, which is still struggling with the effects of high interest rates, as well as elevated construction costs and a shortage of skilled labor. In April 2022, the German Construction PMI fell below the 50 threshold and the downturn has only intensified since then, hitting record lows in the past months. While all subsectors remain in contraction territory, residential is clearly the most troubled one that is dragging down the overall activity level (Figure 6). High interest rates not only pushed down housing prices but also weighed on German builders' capability to borrow, deteriorating the liquidity that is essential to get projects off the ground. In addition, construction costs have jumped by +23.3% from Q1 2021 to Q3 2023. Though building material prices have stabilized and trended downwards in recent quarters as a result of easing supply-chain disruptions, labor costs in the construction sector have kept rising at an above-average rate amid a shortage of

skilled labor. More recently, the IG BAU, a German trade union, initiated new rounds of collective bargaining last week, requesting a EUR500 monthly wage increase for all construction workers. We estimate a +10.5% uptick in the average hourly wage if the request is accepted, which would position Germany 40.1% higher than the total EU average and significantly above France, Italy and Spain. We expect labor costs to continue to support high construction costs in the long run.

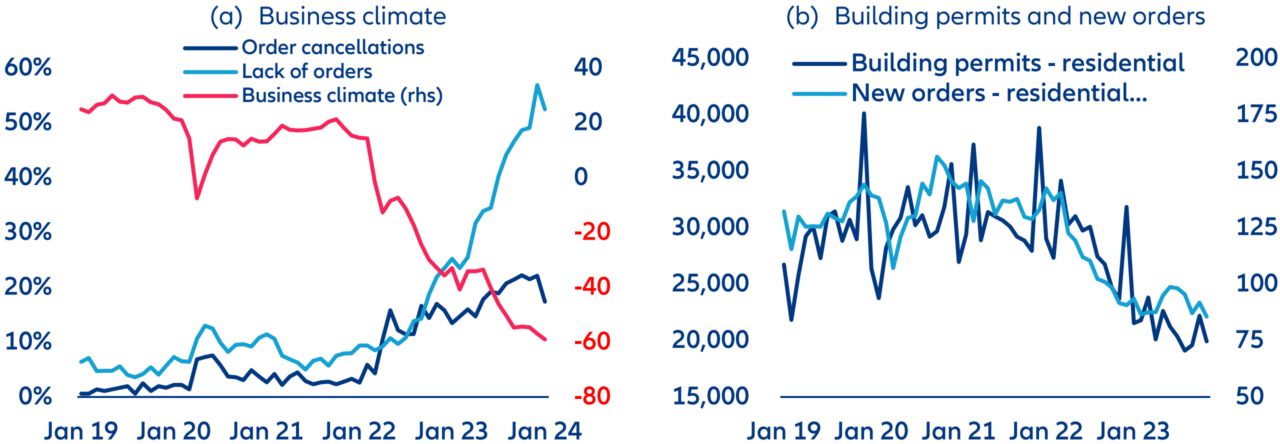
Figure 6: HCOB Germany Construction PMI Activity Index by sector



Sources: HCOB, S&P Global, Allianz Research

Deteriorated profitability has led to a massive slump in construction activities and driven a wave of German developers into insolvency. Order shortages and project scraps have piled up as declining housing prices and upward cost pressures continued to squeeze builders' margins and make projects increasingly unprofitable. According to a survey by the Ifo Institute, 52.5% of respondents reported a lack of orders (+27.3pps y/y) and 17.4% had to cancel their projects (+3.9pps y/y) in January 2024, both showing a slight downtick compared to the previous month but still remaining close to record highs. Consequently, a rising number of German construction companies are facing heightened insolvency risk. Between January and November 2023, 2,822 companies filed for bankruptcy (+14.8% y/y). 293,393 and 295,275 dwellings were built in 2021 and 2022, respectively. But the figure could decline further in 2024, with only 232,000 dwellings permitted (-26.1% y/y) and 1,000 new orders received (-21.2% y/y) between January and November 2023 (Figure 7).

Figure 7: Plummeting activities in residential construction

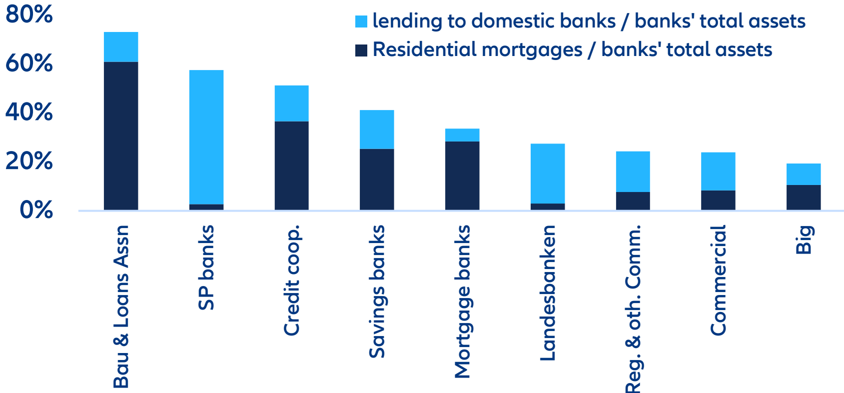


Sources: Ifo Institute, DeStatis, Allianz Research

Spillovers to banks from residential real estate financing are not the most prominent risk for the banking sector in relation with real estate. Within the atomized German banking system, some actors are rather exposed to residential real estate financing, but risks should remain contained in our baseline scenario. Banks have tightened their standards and demand for housing loans has diminished, leading to a significant decrease in approved mortgage loans. This coupled with the fixed terms in "old" contracts has contributed to slow down the transmission

of higher policy rates to borrowers. With unemployment levels contained, this should keep mortgage payments in check. As of today, the insolvencies of real-estate-related companies[2] and commercial real estate mortgages present a larger source of risk than housing mortgages. Should the situation deteriorate, risks from unpaid mortgages would pile up in the banks with concentrated exposure (building and loans associations, mortgage banks but also smaller cooperatives and savings banks, Figure 8) while larger banks with more diversified exposure – and subject to tighter controls – should be able to handle it better. However, in such a scenario, the risks could also spill over through interbank linkages, especially via Landesbanken and special purpose banks, which play a crucial role in the network of smaller banks.

Figure 8: Concentration of exposures to house mortgages and domestic bank lending by bank type

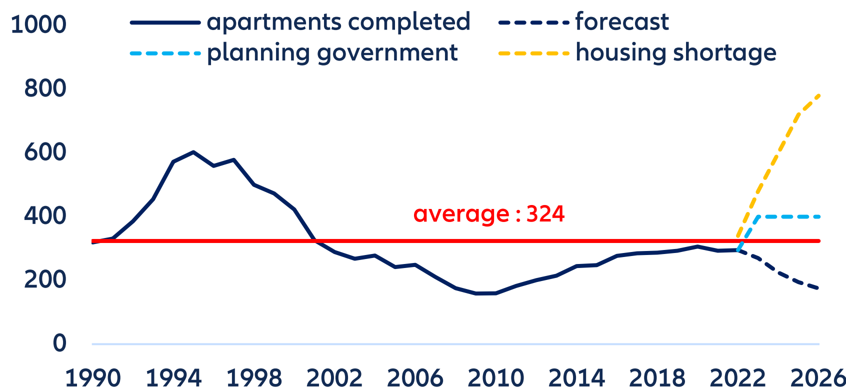


Sources: LSEG Datastream, Bundesbank, Allianz Research

Building is simply too expensive at the moment, but the housing shortage has become a social issue. The rapid rise in construction and energy costs has made residential construction unprofitable. With state-induced costs accounting for 37% of the total expenses, a square meter of construction can cost over EUR5,000. This would need to be compensated by an average rent per square meter of EUR21, which is simply not financially viable for many. This financial imbalance has led to a low rate of apartment completion, which is expected to decrease further in the years to come and lies far below the government target of 400,000 flats per year. Nor does it suffice to address the forecasted housing shortage, which will massively increase further until 2026 (Figure 9). To address the housing shortage, it is crucial for the government to intervene and bridge the gap between completed and needed apartments. The German government has proposed a comprehensive package aimed at revitalizing the construction sector, but implementation will take time. Measures such as faster planning and approval processes and improved depreciation options will eventually help stabilize the market. Yet the high ratio of state-induced costs in Germany is attributed to various factors including taxes, energy requirements, technical regulations and municipal requirements. To boost construction – which makes up about 6% of German GDP and thus has a significant potential to contribute to German growth or decline – the residential real estate sector needs tax incentives to limit construction costs, assured reliable funding and efficiency in climate protection in combination with a duly needed reduction of uncertainty.

[2] *In many cases highly indebted. According to Destatis, 30% of outstanding bank loans relate to companies in this sector.*

Figure 9: Completed apartments and forecasts, in thousands



Sources: LSEG Datastream, ifo Institute, German government, ZIA, Allianz Research. Forecasts from 2023 (inc).

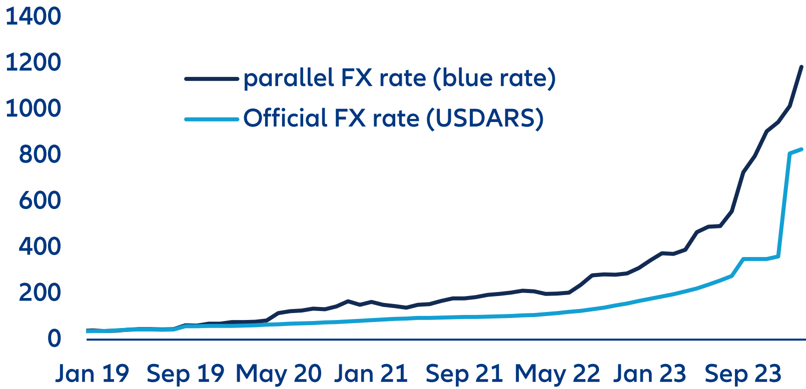
A catch-22 for Argentina

Argentina's President Javier Milei suffered a major defeat this month when his ambitious economic deregulation package – known as the Omnibus Law – was rejected by Congress (Table 1). This means that it will have to be re-examined by committees and then presented to the plenary for a new general vote. The bill was approved in general terms by the Chamber of Deputies earlier this month but the analysis of individual articles sparked a stalemate, particularly with regard to the transfer of federal taxes to provinces and privatization. This defeat shows that the risk of governability will be high under Milei's tenure since his party, La Libertad Avanza (LLA), holds a minority in both houses of Congress and has little representation in the provinces. The authorities have announced that all negotiations with provincial governors and opposition legislators have been suspended and that the bill will not be returned to Congress.

Further compromises are likely as part of extended negotiations. If the law does not go through, the government will have to cut spending more than planned to meet fiscal targets, which it says remain non-negotiable. This will certainly put provincial governors in a difficult position as their finances will be affected by lower federal transfers, making negotiations with the government all the more essential. The government could hold a non-binding referendum to demonstrate popular support for its agenda. But relying on a continuing honeymoon period with the population to pass tough reforms could be risky as Argentinians are suffering from the ongoing economic adjustments. Should Milei call a referendum and lose, he would be a weak target just a few months into his first year in office, which would threaten political stability further. In this context, negotiating appears to be the best approach. The government is likely to pursue reforms through normal legislative procedures. But this means that the pace of reform is likely to be slower and the degree of policy dilution certainly greater, limiting the scope of meaningful changes**.**

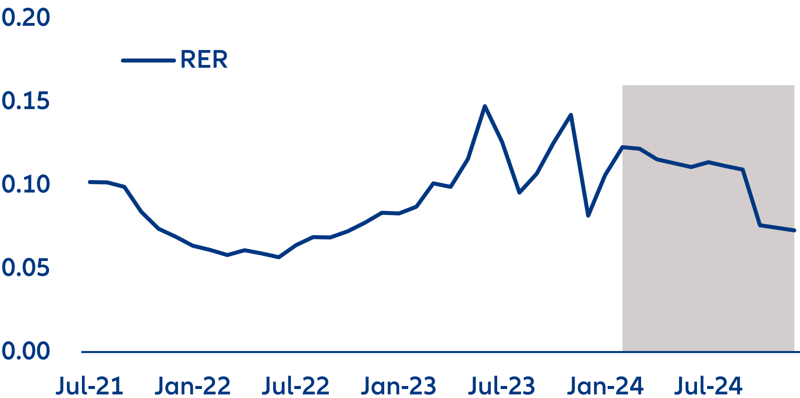
Meanwhile, the economic adjustments continue and will be painful in the short term. Milei's government began its tenure with two main goals: rebalancing relative prices, i.e. via a currency devaluation, and fiscal consolidation. In December, the currency was significantly devalued (-54%) and the government adopted a crawling peg, with a depreciation rate of 2% per month (Figure 10). This measure was urgently needed to restore the country's competitiveness as the Argentine peso was artificially overvalued, undermining exports. While this was a necessary move, it has had immediate and significant consequences because the pass-through to inflation is too high. Indeed, inflation is galloping, reaching over 200% in January, and we expect it to reach 300% in Q2, given the pass-through of the exchange rate devaluation to prices combined with the reduction of subsidies in energy and transport. In this context, it is very likely that the government will increase the monthly rate of currency devaluation in the coming months as inflation offsets the competitiveness gains from December's devaluation. Assuming that the current devaluation rate will be 2% until December 2024 – that is, a further devaluation of around 130% in one year (Dec/2023-Dec/2024) – and given our inflation scenario, a competitiveness gain would only be observed at the end of the year (Figure 11).

Figure 10: Official and parallel exchange rates



Sources: Refinitiv, Allianz Research

Figure 11: Argentina's real exchange rate (RER)



Sources: Refinitiv, Allianz Research. Note: higher values mean less competitive.

At the same time, the government's ambitious fiscal consolidation goals will mean severe cuts to expenditures. The government has set a target of reaching a primary surplus of 2% in 2024, most of which would be achieved through reductions in expensive energy and transport subsidies, a freeze on capital spending and a reduction in transfers to the provinces (Figure 12). For now, the government seems to be succeeding, with Argentina reporting its first monthly budget surplus in 12 years in January. However, implementation is at risk because the government has not been able to raise taxes, even temporarily, and further spending cuts seem complicated at a time when more than half of government spending goes to pensions and social assistance, the economy is facing stagflation and more than 55%[3] of the population lives in poverty. It should be noted that the seventh review of the IMF program, showed confidence in the new government's policies and that the current macroeconomic environment will be adjusted. Clearly, the change in policy direction has helped Argentina secure waivers for missing the 2023 targets and put the program back on track. Among the key points of the new revision is the complete elimination of monetary financing of the fiscal deficit in 2024, but the lack of political support could ultimately jeopardize such renewed support.

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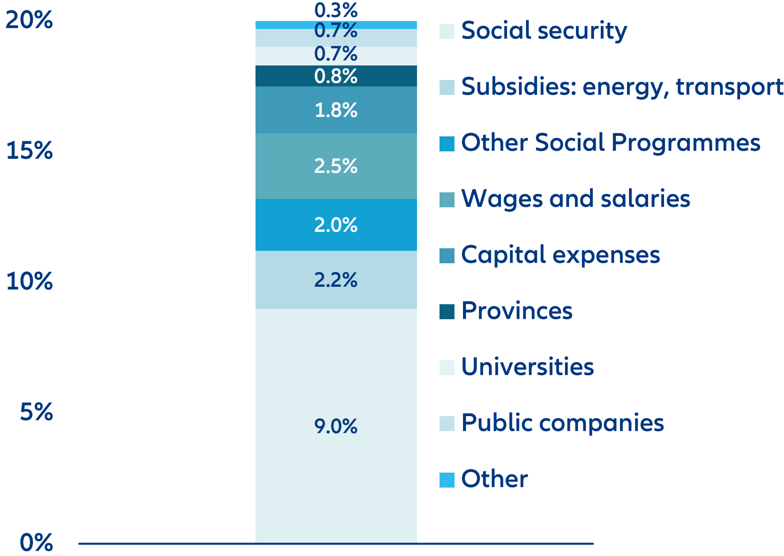
[3] *According to the Social Debt Observatory of the Catholic University of Argentina, Argentina's poverty rate reached 57.4% in January, up from 49.5% in December, the highest level since the observatory began publishing reports in 2004.*

Figure 12: Composition of fiscal expenditures (% GDP, cum. 12m).



*Sources: Bloomberg, Allianz Research. *December 2023.*

The context of high inflation and fiscal contraction means that consumers will be hit particularly hard. We expect real income to be decline by nearly -10% in 2024, strongly hitting consumption. In this scenario, we expect negative GDP growth of -2.5% in 2024, with the recession being partially offset by an increase in exports, especially supported by strong agricultural harvests of corn and soybeans (analysts expect growth of more than 64% and 160%, respectively), which together with wheat account for about 45% of the country's exports. This, together with further improvements in the energy balance and a sharp reduction in imports, could help the current account move to a surplus of around 4% in 2024. The economy would start to recover in late 2024 as the initial headwinds fade and distortions are removed. For the time being, we expect growth to rebound to around +2% in 2025, driven by exports and a general improvement in the country's economic sentiment due to adjustments and progress in reforms. Of course, this will depend on the resolution of the political turmoil and continued reforms, and risks remain high.

Table 1: Argentina Omnibus Bill (key proposals out of 664 articles).

Category	Regulation	Details
Deregulation	Antitrust Law	Repealed. Proposes the creation of a new regulatory body
Pension	Suspends current pro-cyclical formula	Implements a temporary discretional system where Executive can set adjustments before a new formula is designed and approved
Debt	Repeals Law that dictates that any new FX debt issuance has to be approved by Congress	Offers discretion to the Executive
Fiscal/Tax	Moratorium	Tax, customs, and social security debt with up to 50% discount
	Amnesty on undeclared assets/holdings	Applies to domestic and foreign assets. Up to USD 100K, no taxes owed. Beyond that, tax rate increases progressively depending on timing (5, 10, and 15%)
	Asset tax	Creates special regime until 2027, with a special (lower) rate if taxpayer decides to pay tax upfront for next 4 years, avoiding paying taxes on new assets acquired during this timeframe. Otherwise, tax rate falls gradually over time.
	Excise	Higher taxes for tobacco industry
	Export taxes	Mostly all exports will pay a 15% tax. Oil and mining tax rates unchanged. Tax on soybean exports up to 33% (from 31%). Lower taxes also for lemons and wine exports
	Privatizations	Declares 41 SOEs subject to privatization, among which we have the national oil company YPF, the state airline Aerolíneas Argentinas, and the water company (AySA)
	Creating a business	32 laws would be modified to simplify the creation of businesses
	Public Sector Assets	Consolidation of public sector assets, excluding BCRA
Energy	Liberalization of prices	Free domestic prices (aligned with international prices) and export prices
	Royalties	No longer a fixed and single royalty rate. Auctions will make participants compete on royalty rates above a 15% floor
	Concessions	Annuls existing ones. New concessions to be auctioned.
	SOEs	Eliminate privileges. No monopoly on special zones/regions
Labor	Plan to regulate employment	Benefits for companies that create new jobs. No criminal actions on employers. Regularization of debts.
Electoral system	Elections	Eliminates PASOs Reforms system to elect Lower House Representatives by picking a single winner in 254 jurisdictions instead of proportional representation.
Public Works	Allows renegotiations of contracts signed prior to December 23, simplifying rules for concessions.	
Criminal System	Road blocking	Raises fine for those cutting transit
	Protests	Need to be notified ahead of time and can be rejected. Organizers of protests are liable for damages

Sources: Government, MS Research.

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

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