

REPORT ON THE ECONOMIC SITUATION

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Economic outlook during stagflation

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The hysteria of last summer has made way for cautious optimism. All indications are that the German economy will survive the winter of 2022-2023. It seems that the warnings in the summer of 2022, namely that Germany is facing its worst economic crisis since the Second World War, were totally overblown. Based on the current situation, it seems likely that Germany will experience a "normal" recession with a slight reduction in the GDP - provided there are sufficient energy supplies, which seems to be the case in view of the all-clear given by the Federal Network Agency (Bundesnetzagentur).

So far, so good - or bad: Because it means that the German economy has entered a stagflationary phase. It is not clear where the economic growth is supposed to come from over the course of the year. The economy is languishing. Then there is historically high inflation. Inflation in 2022 was the highest since the German mark was introduced in 1948. And inflation will remain high in 2023. This will require the European Central Bank (ECB) to continue its restrictive monetary policy. It will have to raise the prime rate until positive real interest rates are achieved over the entire yield curve. The ECB has already announced the gradual reduction of its balance sheet, so that government bonds that come due will no longer be entirely replaced by purchases. In addition, the expiry of the targeted longer-term refinancing operations (TLTRO) will also withdraw liquidity from the market.

The most recent news about lower inflation rates should not be misinterpreted. There are no signs that the inflation process is slowing down. The lower inflation rate in December 2022 compared to the previous year's month (8.6% in Germany, 9.2% in the Eurozone) is mostly the result of various efforts to keep the lid on energy prices. In Germany, the lump-sum payment to consumers (which was introduced to contain gas prices for December) has an anti-inflationary effect. The "brakes" that have been put in place for gas and electricity bills are also expected to have certain

mathematical effects on the inflation rate in 2023. Added to these are base effects, if this year's energy prices do not rise as much as last year, or if they decrease.

However, compared to the previous year's month, in December 2022 prices in the Eurozone (without taking into account energy prices) rose from 7.0% to 7.2%, while core inflation (with food prices subtracted) increased from 5.0% to 5.2%. Inflation has now reached the entire range of goods and services. Wage increases in EU member states are doing their part to accelerate price growth, even though they are still associated with a reduction in real wages at the moment. And so the price-wage spiral has already started, most likely.

Central banks must decisively counter this inflationary trend, so that inflation moves back to its target value of 2%. Based on the current situation, that is not expected for the year 2024. At the same time, one should not expect to see inflation rates over 2% in the medium term. If inflation cannot be contained by monetary policy, interest rates will have to be raised even more later on, which will lead to more problems, particularly considering the high levels of private and government debt.

Restrictive monetary policies put pressure on economic growth. The construction industry - traditionally very sensitive to interest rates - is already feeling the effects. There has been a massive decline in investments in new construction, and there are signs of price corrections in real estate markets. Therefore the challenges continue to be immense.

Sincerely yours



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