Creditreform Economic Briefs: Moving Forward in Uncharted Waters

Despite the resurging Covid-19 pandemic, the global economy enjoys a sustained economic recovery, also thanks to further progressing vaccination – and booster – campaigns. That said, the recovery remains prone to setbacks, in particular in those countries that are immunization laggards. At the same time, the focus is further shifting towards inflationary pressure that has built up over the last months.

Soaring energy prices and supply bottlenecks mean that inflation concerns are high on the agenda

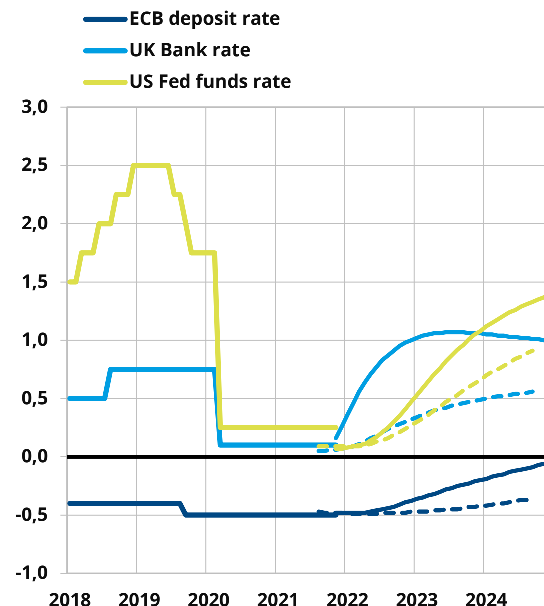
A more or less synchronized spike in demand that has met with disruptions to or shifts within production has led to supply shortages of raw materials and intermediate products, partly exacerbated by labor shortages. As a corollary, inflation rates have reached multi-decade highs in several economies around the world. At this stage, it looks likely that some of the factors contributing to supply-side disruptions may not go away quickly, resulting in a longer-lasting impact on prices than previously assumed.

Against this backdrop, monetary policy has partly started to shift down a gear, also raising the possibility of higher financial market volatility. Central banks of, inter alia, Korea, New Zealand, the Czech Republic, Hungary, and Poland have already hiked their policy rates this year. Given the difficulties to determine whether the current price pressure is of transitory nature or whether it is likely to translate into more structural underlying inflationary pressures, we think that some central banks will prefer to err on the cautious side. Still, forward guidance among major central banks indicate a somewhat less accommodative stance, prompting market expectations for key policy rates to move up (see Figure **1**).

Moreover, with a view to shoring up the medium-and-longer-term growth outlook, ever more resources are allocated towards the twin transformation – digital and green – that has to be engineered in most economies, with a rising number of governments committing to more or less ambitious climate goals, as seen during the recent UN Climate Change Conference (COP26) in Glasgow. In this context, the European Commission looks set to become the largest issuer of green bonds against the backdrop of its NextGenerationEU (NGEU) program, potentially strengthening the international role of the euro.

Figure 1: Markets expect a faster tightening in policy rates on both sides of the Atlantic, albeit less so in the euro area

Policy rates in %, curves are based on Bank of England estimates using forward overnight index swap rates, solid lines: 27-Oct-21 and dashed lines: 28-Jul-21

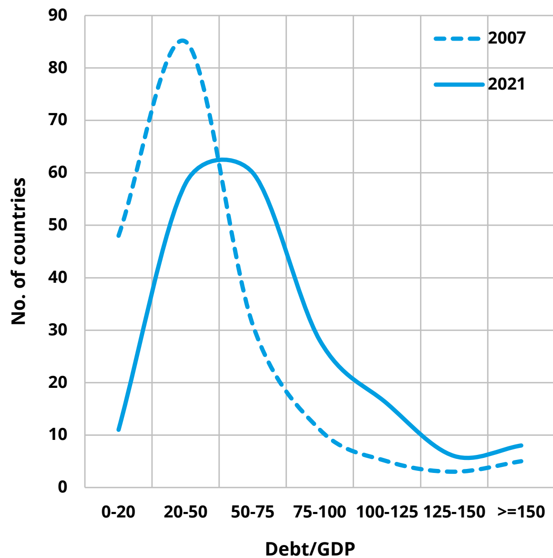


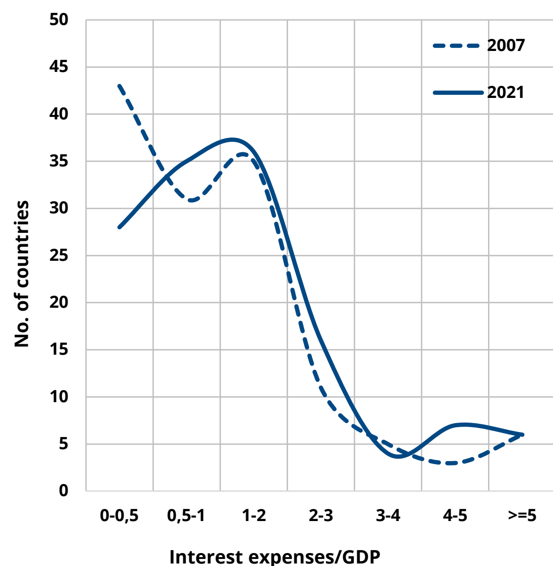
Sources: Bank of England, Creditreform Rating

Contributing to a delicate mix of circumstances, these challenges will have to be dealt with in an environment of widely stretched public balance sheets owing to the pandemic, putting considerable pressure on monetary and fiscal policy to act carefully as support is to be withdrawn and NGEU funds will have to be allocated wisely. Despite significantly increased debt levels, the cost of servicing the debt has not changed much since the Global Financial Crisis (see Figure **2**).

Figure 2: Debt increased significantly, but servicing costs have remained broadly unchanged since the Global Financial Crisis

Debt-to-GDP and Interest outlays-to-GDP both in %, panels 1 and 2 cover 188 and 180 countries respectively





Sources: IMF, Creditreform Rating

Looking forward, supply-chain problems related to transport capacity may be about to ease somewhat, as suggested by the Freightos Global Container Freight Index (FBX). Meanwhile, demand for intermediate products such as semiconductors is likely to stay very high throughout next year while possibly meeting with supply shortages due to geopolitical power play, as recently exercised between the US and China, affecting production, as well as disrupted production owing to local outbreaks of Covid-19 in various places.

That said, having recovered early from the initial coronavirus wave in 2020, China may experience a slowdown of economic activity in its industrial and construction sector in 2022. This could be compounded by recent financial difficulties of one of its major real estate developers that might entail downward risks for the whole property sector and possibly beyond, potentially dampening China's demand for various raw materials. Furthermore, production and extraction of commodities in South America may be increased among easing restrictions as Covid-19 infection rates ebb and vaccination progresses, as well as in light of increased investments in the respective industries.

IMF nudging down its 2021 forecast due to short-term headwinds

Amid all these factors, the IMF has slightly downgraded its forecast for global economic growth in 2021 to 5.9% this October, from 6.0% projected in July, which masks differing underlying trends. While it revised down the outlook for advanced economies, partly because of the adverse effects of supply-chain disruptions, the downgrade for low-income developing countries occurred against the backdrop of a worsening epidemiological situation in those countries amid low vaccine supply. With regard to emerging market and developing countries overall, however, the IMF slightly increased its forecast for the whole year 2021. The growth projections for China were only slightly revised down, by 0.1 p.p. for 2021, to 8.0%.

With a view to 2022, the IMF maintained its forecast of 4.9% for global economic output expansion. Advanced economies could see their GDP rise by 4.5% next year, still likely outpaced by an expected expansion of 5.1% in emerging market and developing countries. Aggregate output for the industrialized countries is expected to reach its pre-pandemic trend level in 2022, whereas aggregate output for the developing nations (excluding China) is projected to

take much longer to catch up, as it is estimated to still stand 5.5% below its pre-pandemic level in 2024.

Meanwhile, Chinese economic growth is expected to edge down to 5.6% in 2022. Following the financial difficulties of Evergrande, the Chinese housing sector might experience a more pronounced slowdown, as well as due to downside risks related to another outbreak of Covid-19. We believe that that the Chinese leadership may thus well provide additional economic stimulus for 2022.

US gearing up for a first rate hike next year

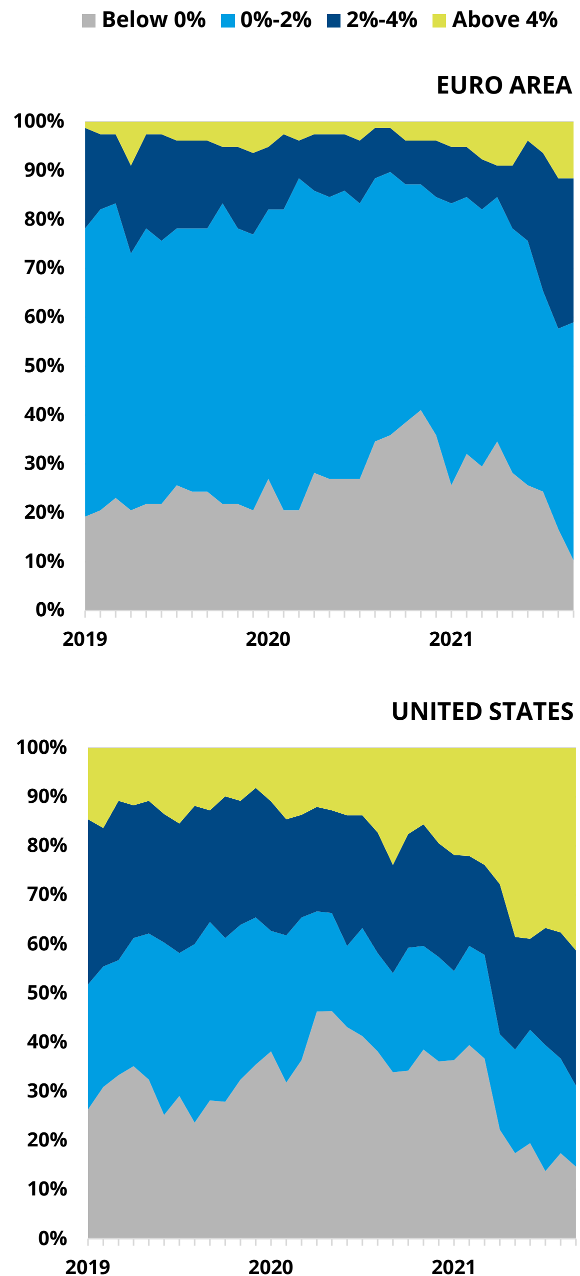
The US economy has continued to expand throughout the year, and is on course for an increase in real GDP of about 6.0% in 2021, down by 1 p.p. compared to August's Briefs edition, mainly owing to supply-side shortages, whilst demand remains robust. Private consumption should be the key driver of economic growth in 2021/22, bolstered by robust employment and wage growth, as well as by large fiscal support, which, however, is set to wane in 2022. Public and private investment is likely to add considerably, backed by the infrastructure package signed into law by President Biden in November, including USD 550bn in new federal investment in digital and transport infrastructure.

In its latest quarterly projections provided in September 2021, the Federal Reserve expected real GDP to come in at about 5.9% in 2021 and to moderate to 3.8% and 2.5% in 2022 and 2023 respectively. Against the backdrop of headway made towards reaching full employment and current upward pressure on prices, the Federal Open Market Committee (FOMC) announced that it would begin tapering from the current month at its meeting on 2-3 November 2021. It intends to reduce its asset purchases by USD 15bn per month (10bn and 5bn less in Treasury securities and MBS respectively), from a previous pace of USD 120bn per month.

The Fed stressed that tapering should not be understood as signal for an imminent rate hike. However, even if inflation rates start to moderate around the middle of next year, we think that a first rate rise may occur towards the end of 2022, not least at price increases are already more broad-based (see Figure 3).

Figure 3: Inflationary pressures in the US are materially more pronounced and broad-based than in the euro area

Distribution of items in the Harmonized Index of Consumer Prices (EA) and the Consumer Price Index (US), both less food and energy, for the EA and the US we included 78 and 111 items respectively



Sources: Eurostat, BLS, Creditreform Rating

According to latest FOMC communication from Sep-21, it anticipated the Fed funds target rate to be at around 0.3% in 2022, and around 1.0% in 2023, both constituting slight upward revisions compared to the June forecasts. Recent inflation developments have seen the US CPI rise to a 30-year high (October 2021: 6.2%). Price pressure is likely to be temporary, but assumed to persist well into next year, on the back of supply chain bottlenecks and shortages that should abate in the course of 2022. The core inflation rate, here excluding food and energy prices, has trended up as well, reaching 3.1% in October 2021.

Euro area: Hard times ahead for the immunization laggards as we move into winter

Following an easing of containment measures, quarterly growth momentum continued in the euro area, with real GDP rising by another 2.1% q-o-q in Q3-21. While France, Italy, and Spain surprised on the upside, posting a quarterly expansion of 3.0%, 2.6%, and 2.0% respectively, Germany seemed more affected by the abovementioned supply bottlenecks and the manufacturing weakness, recording an increase of 1.8% vis-a-vis the second quarter. However, measured against the respective pre-pandemic level (Q4-19), Spain continues to lag well behind the other three euro area heavyweights, posting 6.6% below its pre-crisis GDP path as of Q3-21, whereas France has almost recouped lost ground (-0.1%).

We expect the economic recovery to continue in the euro area amid progressing vaccinations, although ongoing supply bottlenecks (see Figure **4**) and some epidemiological setbacks will likely weigh somewhat on growth rates going forward.

Illustrating these points, the most recent Composite Purchasing Manager Index (PMI) slowed to the lowest level in six months in October, amid a third consecutive monthly decrease. Nevertheless, at 54.2 points, the indicator still suggests ongoing expansion of economic activity. Monthly industrial production in the euro area has posted two consecutive declines as of September. By comparison, consumer-related data such as the monthly volume of retail sales and consumer confidence have held up better. As of October, consumer sentiment compiled by the European Commission was moving slightly above levels recorded before coronavirus struck, having recovered significantly in spring as social distancing was eased.

Figure 4: Supply-chain disruptions represent major headwind to near-term outlook, with Germany standing out in particular

Share of survey respondents citing shortage of material/equipment as a factor limiting production, by industry in %; values above 100 are explained by seasonal adjustment of the respective time series

	EA	DE	ES	FR	IT
Manufacturing	53	86	27	43	18
Coke / petroleum products	36	100	0	12	5
Basic metals	30	55	8	11	8
Computer / electronic products	75	102	37	51	25
Electrical equipment	81	109	42	65	39
Motor vehicles	87	102	55	140	34

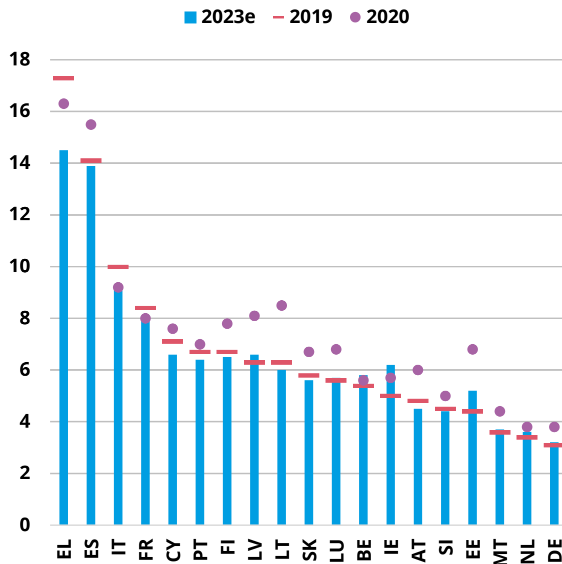
Sources: European Commission, Creditreform Rating

Generally, we assume that growth of real GDP should mainly be driven by domestic demand in 2021, as private consumption benefits from comparatively resilient labor market developments thanks to extensive government support and upward pressure on wages in some sectors (see Figure **5**). The unemployment rate has come down to 7.7% in September 2021, from a peak at 8.6% in August/September 2020.

Investment is set to be buttressed by favorable financing conditions and initiated funding from NGEU for greening the economies and enhance digitalization. Also, private investment should be facilitated by healthy corporate balance sheets, as reflected by solid data on earnings. Amid recovering exports, net trade should be able to make a positive growth contribution this year. For 2021 as a whole, we anticipate euro area GDP to increase by about 4.9%.

Figure 5: Limited labor market scarring, although unemployment should remain above pre-Covid-19 levels in several euro area members

Unemployment in %, European Commission forecasts for the year 2023



Sources: Eurostat, European Commission, Creditreform Rating

Looking ahead into 2022, we expect domestic demand, and in particular private consumption, to remain the main driver for growth, while NGEU should enable a stronger expansion of investment than this year. In this context, it is worth recalling that disbursement of the funds is linked to reaching agreed milestones in terms of implementing reforms. With imports likely to rise vividly in this scenario, we assume a smaller positive contribution from net exports in 2022, despite an expected further increase in exports. Overall, we assume GDP growth to come to 4.4% next year.

Risks pertaining to the pandemic remain in place, and the euro area's fiscal policy stance should stay supportive going into 2022

Apart from the mentioned risks owing to bottlenecks on the supply side, downside risks to growth in the short term mainly relate to currently resurfacing coronavirus infections in various countries. These seem to be linked to the respective share of the population still unvaccinated, which varies considerably among the member states. With surging infections in those euro area members falling well short of herd immunity threatening to overwhelm the health system, containment measures will likely be re-introduced, as currently witnessed e.g. in Austria and the Netherlands, pointing to increasing headwinds to economic growth as the euro area economy is approaching the turn of the year.

While Austria has re-entered a nationwide lockdown on 22 November and intends to impose mandatory vaccination against Covid-19 from February 2022, the Dutch government has, among others, restricted opening hours for shops and catering establishments including restaurants and cafes. Similar developments may soon follow in Germany, where pandemic-related hospitalization numbers and intensive care cases are rising rapidly.

Having been extended in the course of the year, but largely assumed to phase out early in 2022, fiscal support measures such as wage supplement schemes, moratoria and favorable business loans are thus likely to be re-applied or further extended across a number of euro area members, in order to avoid deeper scarring from this pandemic, while adding to the fiscal burden. In Spain, the government is planning to replace its wage supplement scheme (ERTEs) with a more permanent one including a stronger focus on re-/upskilling on workers.

With a view to political developments in the euro area, a focus will be on the French presidential elections next year, with the first round scheduled for 10 April 2022. A second round is to be held 24 April, if no candidate wins an outright majority in the first round, which looks likely. Current polls suggest that incumbent president Macron may get to serve a second term, possibly winning in a second round vote against right-wing contender Marine Le Pen. In case of a Macron win, the German-French axis would presumably continue to drive climate protection policies forward, with the recent stronger emphasis of nuclear power in France potentially constituting a point of contention.

Near-term outlook for inflation in the euro area adjusted significantly upwards, but tame underlying price pressures for the time being

As in many other economies, inflation rates in the euro area have gone up substantially over the last months. In October, the annual change in euro area HICP inflation reached 4.1%, the highest level since July 2008, largely pushed up by energy prices, which saw an annual increase of 23.5%. Excluding energy, food, alcohol and tobacco, the so-called core rate was at 2.1% in October, corresponding to the strongest increase since December 2002. Concurrently, service prices have climbed by 2.1% on the year.

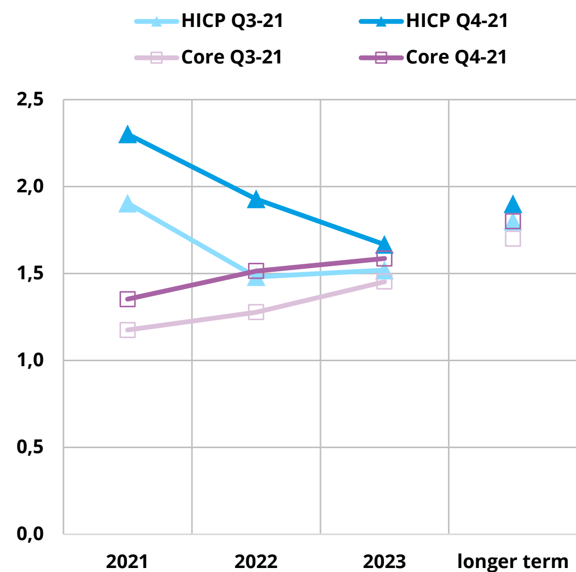
Monetary policy has remained very accommodative throughout this year. Alongside the currently open-ended Asset Purchase Program (APP), the ECB's PEPP, with an overall envelope of EUR 1,850bn, will run until at least 31 March 2022. Reinvestments of maturing principal payments from securities purchased under PEPP until at least 31 December 2023 will add further to the accommodative stance.

Owing to the progressing economic recovery, the ECB Governing Council decided to reduce the monthly PEPP purchases for the first time at its September meeting, but the monetary policy stance remains unchanged. With a view to acknowledged price pressure and high uncertainty over its persistence in a context of economic vulnerability given the lingering pandemic, the ECB is currently stressing three conditions that need to be satisfied before interest rates will start to rise. Apart from inflation reaching 2% well ahead of the end of the projection horizon (currently 2024), inflation would have to be judged as having stabilized durably at the target through the end of the projection horizon, and, thirdly, underlying inflation would have to be judged as consistent with headline inflation stabilizing at 2% over the medium term (see Figure **6**).

At this stage, we would concur with the ECB which puts major emphasis on the assumed transitory character of most recent inflation developments. We thus see three factors as key drivers behind current developments: High energy prices, base effects related to the reversal of the German VAT cut from the beginning of 2021, and recovering demand outstripping supply amid reopening of the economy. Indeed, looking at a more granular breakdown of price groups, upward pressure among different price groups appears not as broad-based as in the US (also see above).

Figure 6: Inflation expectations remain well-anchored regarding the medium to longer term

Annual percentage changes; HICP and core inflation expectations drawn from the respective ECB Survey of Professional Forecasters (SPF)



Sources: ECB, Creditreform Rating

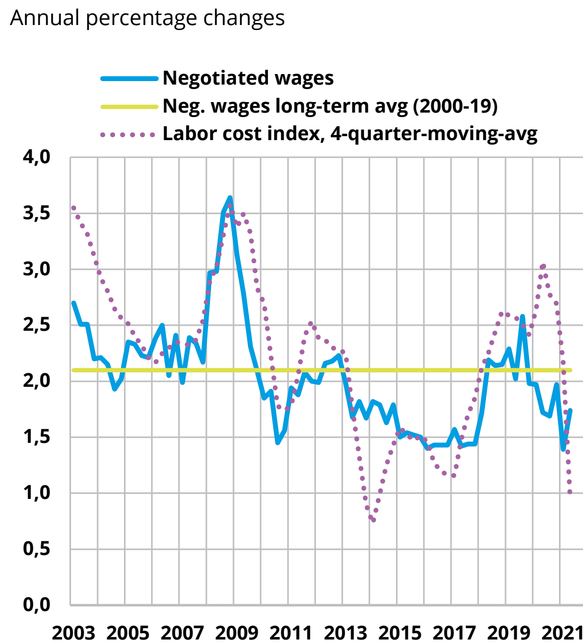
Going forward, a main focus of the Governing Council may thus lie on broad-based wage rises, which have not yet materialized (see Figure **7**). These could be a sign of supply-side shortages translating into more lasting price pressures, and/or a sign of either a more rapid than expected return to full capacity of the economy, or a stronger pick-up than anticipated.

Uncertainty regarding the pace of asset purchases under the PEPP program over the next quarters may at least partly be reduced at the upcoming December meeting. While we do expect the PEPP program to end in March 2022, we assume that the ECB will come up with some sort of smoothing mechanism to avoid a cliff edge. More generally, we believe that the ECB will continue to deliver significant stimulus

through its exceptional monetary operations, including the APP. In our opinion, a first interest rate hike before 2023 seems unlikely at this stage.

Figure 7: Low wage pressures at the horizon do not point to sharp increase of HICP inflation in the near to medium term

Annual percentage changes



Sources: ECB, Creditreform Rating

Against this backdrop, sovereign debt in the euro area should continue to benefit from relatively high affordability, despite likely increasing volatility on financial markets as some other major central banks seem set to act sooner than the ECB (see above).

Review of EU economic governance: Quo vadis?

The activation of the general escape clause of the Stability and Growth Pact, which allowed the member states to provide a forceful response to the crisis, resulting in ballooning general government deficits and debt levels, will continue to apply in 2022 and is expected to be deactivated in 2023.

Meanwhile, the European Commission launched a review of the EU's economic governance in October, aiming to reach consensus on possible changes to the economic governance framework ahead of 2023.

Some initial guidance as to a possible way forward is envisaged for the first quarter of 2022.

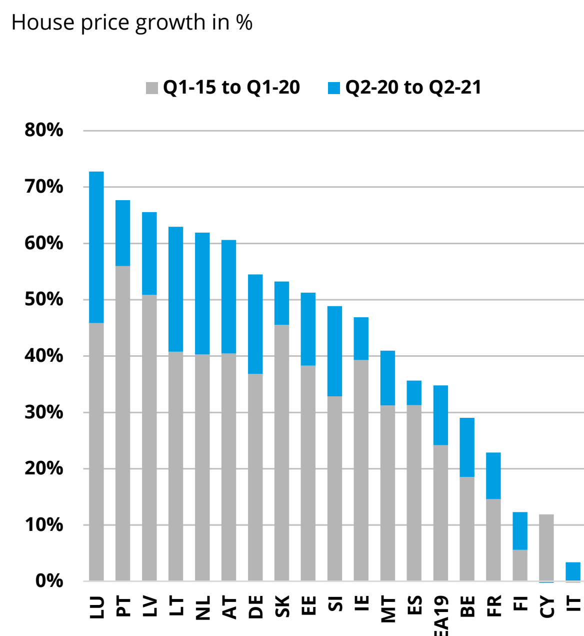
In light of the major challenges of having to engineer and finance the twin transition (green and digital) in a context of higher deficits and debt levels, we think emphasis on the quality of debt may become even more prominent against this backdrop, further watering down a governance framework that has gained in complexity over time. Potentially, this could increase risks to financial stability in the medium to longer term.

Real estate could add to vulnerabilities regarding financial stability

Apart from stretched public balance sheets, house prices have developed dynamically in various euro area countries, partly leading to some overvaluation and as such increasing financial stability risks as larger corrections might occur at some point. Ongoing favorable financing options, partly coupled with incentives for property purchases for certain groups, e.g. first-time buyers, have contributed to this, as have some structural shifts associated with preference for working from home (see Figure **8**).

Figure 8: Already strong house price growth has gathered pace in the wake of the pandemic

House price growth in %



Sources: Eurostat, Creditreform Rating

While insolvencies have hardly gone up amid long-lasting moratoria and efforts to avoid any cliff-edges upon their expiry, there remain risks of a worsening situation that might see more households struggle to service their mortgages, possibly leading to more painful price corrections.

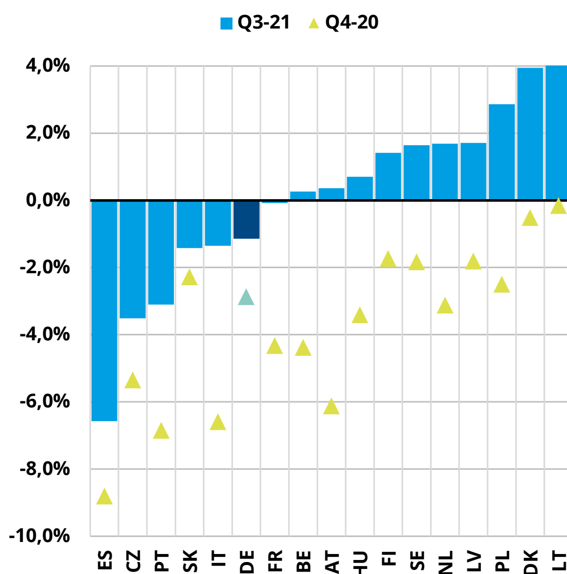
These risks notwithstanding, the banking sector has remained rather resilient throughout this crisis, featuring still solid capitalization levels and improving asset quality. While challenges to profitability remain an ongoing issue in the persisting low-interest rate-environment, a stronger focus will have to be on any signs of deteriorating asset quality going forward. With a view to wider financial stability and associated risks, we note that equity markets, as well as other, more risky, assets have seen large inflows of capital, partly leading to stretched valuations and increasing risks for larger corrections.

German is struggling to cope with shortages

The German economy continued to grow following the easing of restrictions in Q2-21. Despite another increase by 1.8% GDP in Q3, real GDP is still falling 1.1% short of its pre-pandemic level (see Figure **9**).

Figure 9: German economy recovered strongly during the summer months, but trailing many peers

Real GDP as compared to pre-pandemic level in Q4-19

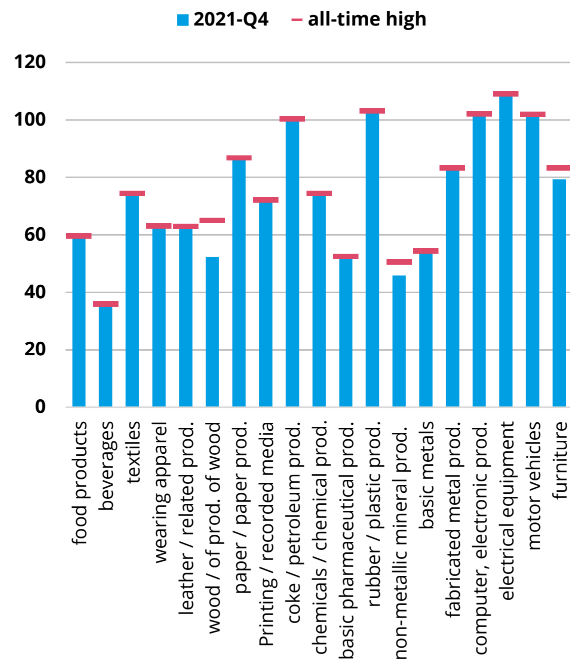


Sources: OECD, Creditreform Rating

Part of the explanation is the larger exposure to the global supply bottlenecks given Germany's pivotal automotive and machinery industry. Survey indicators corroborate the impression that the largest euro area economy, and in particular its manufacturing sector, is heavily affected by these disruptions (see Figure **10**).

Figure 10: German manufacturing sectors hitting all-time highs across the board in terms of supply shortages...

Share of survey respondents citing shortage of material/equipment as a factor limiting production, by industry in %; values > 100 explained by seasonal adjustment



Sources: European Commission, Creditreform Rating

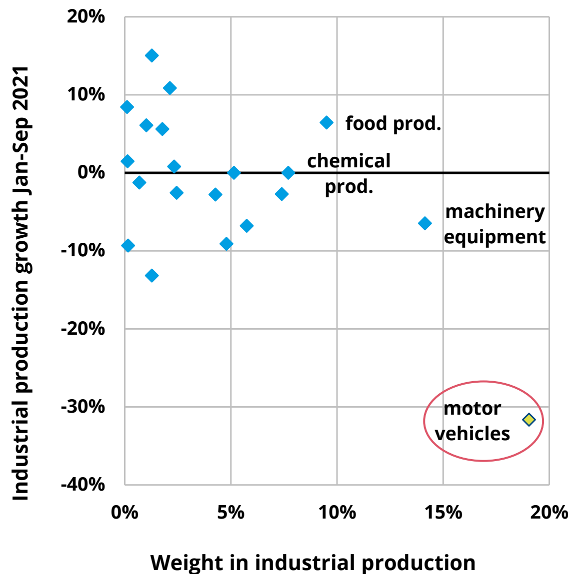
A fourth consecutive decline of the ifo Business Climate indicator in October (index at 97.7), mostly driven by clouding expectations as to the coming months, equally highlights current headaches around these issues. Having said that, sentiment in the manufacturing sector remains significantly more positive than a year ago. Furthermore, despite shortages of some key inputs, the construction sector was able to defy this recent trend, with sentiment con-

stantly improving since July. Contrary to that, optimism in retail trade seems to have suffered the most since June.

With industrial production and exports starting weak into this year's fourth quarter (see Figure **11**), high frequently indicators already hint at a significantly smaller quarterly expansion for the final quarter of the year than in the preceding quarter. We assume the quarter-on-quarter rate will be rather flat. While new orders in the manufacturing sector rose by 9.6% y-o-y in September, unfilled orders are up 24.6% compared to February 2020, before restrictions were introduced in Germany. The range of order stocks reached a new high since inception of the time series in 2015, climbing to 7.4 months in September.

Figure 11: ...with severe repercussions on industrial production, most acute in the German auto sector

Manufacturing sectors' weight in 2019 total industrial production in % (x-axis), industrial production between Jan-21 and Sep-2021 by manufacturing sector in % (y-axis)



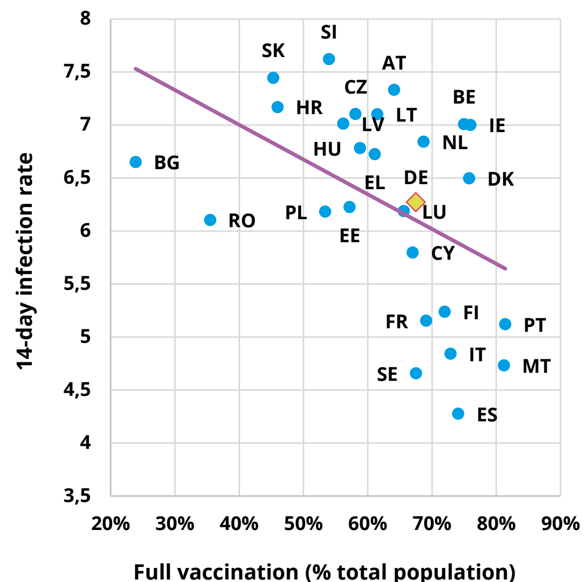
Sources: Eurostat, German Federal Statistical Office, Creditreform Rating

Germany in the Covid-19 pandemic: The same procedure as every year...

Worse still, as Christmas is inching closer, fast rising Covid-19 infection cases intensify worries over the short-term economic outlook, as, similar to some fellow euro area economies, Germany may be forced to re-introduce containment measures. Its 14-day incidence rate has reached record levels in this pandemic, standing at 529.3 as of week 45 (ECDC), and a first of three newly-introduced thresholds for nationwide restrictions linked to the hospitalization rate has already been exceeded. As of 19 November, 67.5% of the total population were fully vaccinated, moving only in the middle-field among the EU countries (see Figure **12**).

Figure 12: Advances in vaccination coverage is a prerequisite for less strict containment measures as we move into winter

Uptake full vaccination in % of total population as of 19-Nov (x-axis), 14-day cumulative infection rate per 100,000 population (week 45) on a ln(e) scale (y-axis)



Sources: ECDC, Creditreform Rating

With the inoculation rate not sufficiently high, vulnerability remains evident, and may be exacerbated by political failure to act quickly and decisively, not least as Germany's new government is not yet in place and

the federal governance structure requires a higher degree of coordination.

For 2021 as a whole, we now expect German total economic output to rise by 2.7%. Private consumption will likely be rather flat, due to strong declines in the first two quarters of this year, when the end of the VAT cut added to the negative effects from a long lockdown period. Rather, government consumption and gross fixed capital formation will contribute positively to real GDP growth, while net trade may only make a small positive contribution, despite recovering exports.

Given a likely weak end to the current year, the economy should see catching-up effects from delayed production in the course of 2022, although supply-side bottlenecks may last well into next year. At this stage, we anticipate GDP growth to accelerate to 4.5%, with private consumption bouncing back forcefully and investment strengthening, thus taking over from government consumption as a major growth pillar. In light of an expected strong expansion of domestic demand, net trade is likely to contribute only moderately to GDP growth next year. The pre-crisis level in terms of GDP may only be reached towards the middle of next year.

Thus, growth prospects remain positive, and continue to be backed by benign labor market developments, release of pent-up demand by consumers, as well as by favorable financing conditions, as monetary policy looks set to remain accommodative. In this environment, residential construction will also remain a supportive pillar to growth. When supply disruptions eventually ebb, non-residential construction will likely gather some pace as well, and global economic activity should accelerate, creating tailwinds for exports. Adding to the latter, EU economies will benefit from a boost via NGEU-linked investment.

Labor market recovering from the pandemic, but real wages hit by higher inflation

The recovery on Germany's labor market, which benefited from extended short-time work, has continued, with the monthly unemployment rate stable at 3.4% in September (Eurostat), having peaked at 4.1% in the course of the pandemic. With that, German unemployment is all but back to pre-pandemic levels.

Willingness to hire among German companies remains strong, judging by the ifo Employment Barometer, notwithstanding a slight dip in the index in October. Similar to shortages of certain products or materials, shortages of skilled staff remain a problem for many businesses, as expressed in numerous surveys.

While this has not yet led to broad-based upward pressure on wage growth, this could become a driving factor further out, potentially adding to current consumer price pressures In the exceptional year 2020, nominal wages fell by 0.7%. Taking into account a mild increase of 0.5% in consumer prices in that year, real wages ultimately fell by 1.1%. Despite an expected increase in nominal wages in 2021, due to significantly less short-time work, real wages might still be negative owing to higher inflation. Nominal wages, which rose by 5.5 y-o-y in the second quarter, were thus partly driven by base effects.

Compared to the year 2020, when German inflation (HICP) was at a mere 0.4%, 2021 looks set to take consumer price increases back to levels last seen shortly after the reunification. In October, Germany's inflation rate leapt to 4.6%, the highest rate since August 1993, partly distorted by the reinstated VAT rate at the beginning of the year, which led to a significant base effect in consumer prices. A similar base effect has driven y-o-y increases in energy prices, added to by the introduction of a CO2 charge in the areas of transport and heating from the beginning of 2021. Core inflation (excluding food, energy, alcohol and tobacco) increased to 2.8% in October. Overall, HICP inflation could average 3% this year.

As the mentioned base effects will drop out of the inflation rate at the beginning of 2022, we expect annual changes in consumer prices to decrease markedly. Given still prevalent downside risks for economic prospects due to the evolution of the pandemic, we expect inflationary pressure to be relatively tame in the short term. For next year, we project the inflation rate to moderate to an average of 2.2%, which could give way to real wage increases.

Having said this, a broader-based increase in consumer prices remains possible in a scenario in which downside risks linked to the pandemic fade quickly. With the politically desired transition to more environmentally-friendly energy sources likely to incur further costs, price pressure due to these structural developments is likely to stay pronounced over the coming years.

Insolvencies remain on the decline

Even though most of the special regulation such as suspension of the obligation for over-indebted businesses to file for insolvency has no longer applied from May 2021, the number of actual business bankruptcies has declined further of late. As of August 2021, business insolvencies declined by 2.1% compared to August 2020, and by 36.7% vis-à-vis August 2019. The early indicator for normal business insolvencies fell strongly in October, according to preliminary data, by 29.2%. An exception regarding filing for insolvency remains in place until 31 January 2022 for businesses directly affected by the catastrophic flooding due to heavy rains in some areas in the summer.

While businesses may seem galvanized by government support, consumer insolvencies have more than tripled in August 2021 compared to August 2020, rising by 217.7%. We note, however, that a change in regulation holds responsible for this development, since new regulation applying to requests from 1 October 2020 enables substantially faster proceedings.

New government required to demonstrate clout in a fragmented political landscape

Apart from persistently high uncertainty associated with the coronavirus as long as immunization levels remain disappointingly low, risks to Germany's economic developments further out relate to catching-up potential as concerns use of digital infrastructure in various areas including education. In a consultation paper released in October, the three parties of the prospective traffic-light coalition - SPD, Green party and FDP - prioritize, among others, making the administration more agile and digital, speeding up administrative, planning and approval procedures to increase efficiency with regard to private and public investment.

The prospective coalition also ponders accelerating the phase-out of coal-fired power generation, possibly to be achieved by 2030, which would go against recent agreements to reach this goal by 2038. Amid strong commitment to pursue ambitious climate goals and further develop the Climate Protection Act, all sectors will have to contribute. As regards the labor market, the three parties envisaged to raise the minimum wage in a one-off to 12 euros per hour, among others.

The considerable challenges and costs that are attached to remodeling the economy on a more digital and environmentally-friendly base seem to require a high degree of political clout. In light of a more fragmented political landscape following the German federal election in September, we see a risk of delays in implementing required changes. This said, the negotiations among the aspired-to three-way coalition progressed relatively smoothly, resulting in a coalition contract presented on 24 November. We expect that current caretaker finance minister Olaf Scholz will be elected Chancellor in early December. While the Free Democrats may weigh in to prevent derailing of the debt brake incorporated in the German Basic Law, the fiscal stance may tend to remain on the expansionary side with a view to required financing of the twin transition while aiming to compensate those losing out from it.

United Kingdom: Post-Brexit blues adds to supply shortages amid well-progressing vaccinations

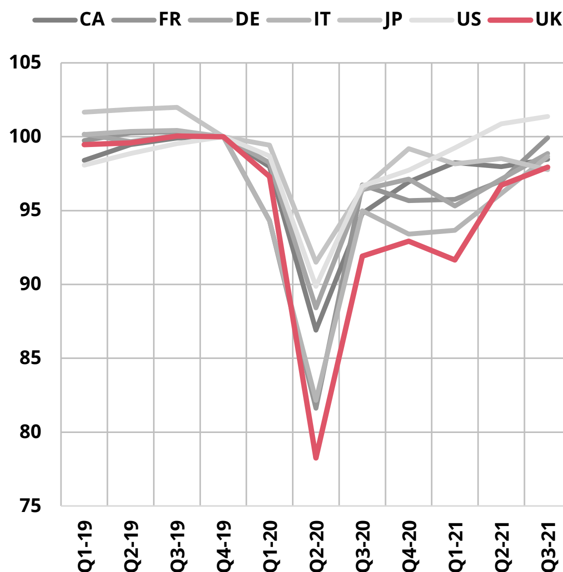
Following its rebound by an upward revised 5.5% q-o-q in this year's second quarter, as restrictions to social life were gradually lifted, UK economic output increased further by 1.3% in the third quarter. With that, real GDP remains 2.1% below its pre-pandemic level, comparing somewhat unfavorably against the other G7 states (see Figure **13**).

While hinting at ongoing growth, the manufacturing PMI had declined for four consecutive months, before improving to 57.1 points in October. The improvement was, however, tamed by another slow-

down in the output component, reflecting the above-mentioned challenges. In the service sector, the PMI leapt to the highest level since July in October (59.1), with the mix of shortages and high demand drastically pushing up prices charged by service providers. Looking at the National Institute of Economic and Social Research's (NIESR) monthly tracker, real GDP could still expand by about 1.1% q-o-q in the fourth quarter.

Figure 13: UK lagging the economic recovery of fellow global leaders

Quarterly real GDP growth in G7 economies, index (Q4-2019 =100)



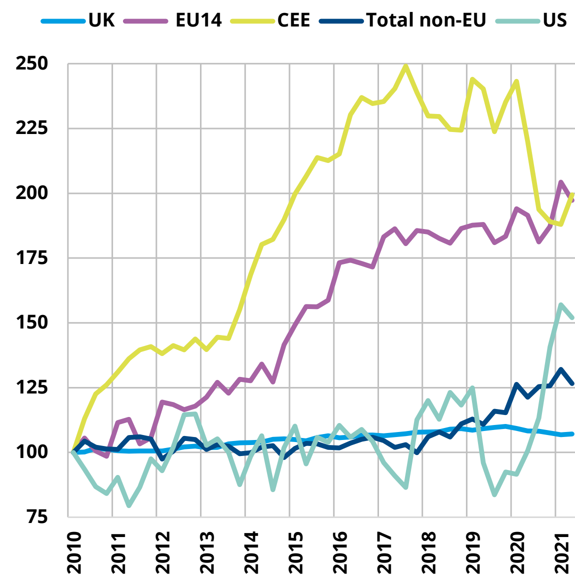
Sources: OECD, Creditreform Rating

As in other economies, the global supply difficulties also leave their mark on the UK economy, coming at an unfortunate time, as they coincide with apparent Brexit-related labor shortages. The recent episode during which heavy goods vehicle drivers were desperately sought-after may serve as an example thereof (see Figure 14).

At the same time, Covid-19 infections in the UK have trended upward over the last few months, dragging along the number of hospitalizations, raising political discussions over whether some restrictions may have to be imposed at some point, despite having had 'Freedom Day' back in July. However, in terms of vaccinations, the UK seems well ahead of e.g. Germany. According to government data as of 15 November, 80.1% of the population older than 12 years were fully vaccinated (two doses), and 22.9% had received a booster dose. Judging by these numbers, the UK is on a promising path to enhance its economic resilience against this pandemic, notwithstanding remaining risks.

Figure 14: UK labor market feeling post-Brexit blues with CEE share taking a dive

UK employment levels by nationality, people aged 16y and over (not s.a.), index (Q1-2010=100), EU14 ⇔ AT, BE, DK, FI, FR, DE, EL, IE, IT, LU, NL, PT, ES, SE



Sources: ONS, Creditreform Rating

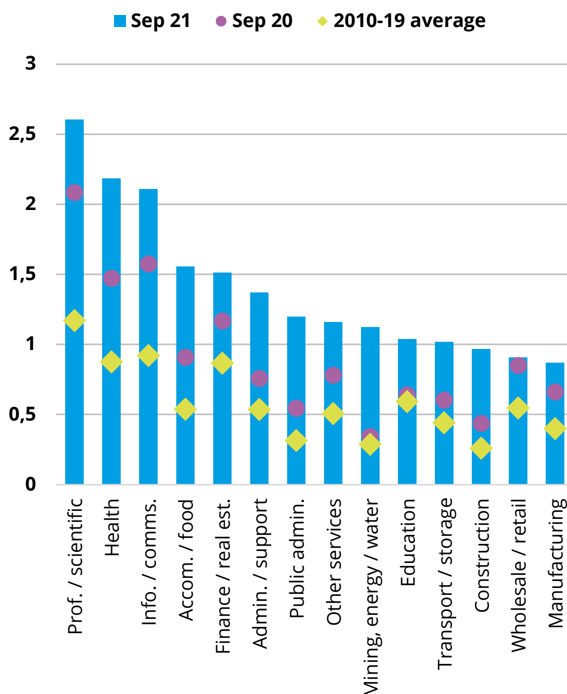
We currently expect real GDP growth in the UK to grow by 6.8% this year, first and foremost backed by rebounding private consumption, and, to a lesser extent, by gross fixed capital investment. Net exports will likely pose a drag on GDP growth this year. The Autumn Budget presented this October would overall reduce somewhat the extent of fiscal tightening over the next two years.

Uncertainty over labor market developments is rather high in the short term, on the one hand stemming from the significant and rising shortages of skilled labor in a number of industries, adding to the

impression of a tighter labor market and creating upward pressure on wages (see Figure **15**). Average weekly earnings in the private sector rose 4.9% y-o-y in September 2021, well above wage growth registered prior to the pandemic in 2019, but likely including positive distortions from employees who have returned from furlough.

Figure 15: Many industries in the UK confronted with increasingly tight labor market, as vacancies relative to unemployment continues to rise

Number of vacancies per person unemployed by industry, three-month moving averages



Sources: ONS, Creditreform Rating

On the other hand, labor market prospects are clouded by the end of the furlough scheme on 30 September. Upon the scheme's expiry, there were still 1.14mn jobs on furlough. The unemployment rate, which had dropped to 4.3% in August, still posting somewhat above pre-crisis levels, might thus go up over the next few months, potentially signaling skill mismatches in the current situation. Wage pressure might then persist.

In tandem with higher consumer prices, some concern over employment prospects may slow down private consumption next year, in addition to income tax thresholds being frozen and a Health and Social Care levy. Gross fixed capital formation should take over as a main growth driver in the coming year, in a context of slightly less accommodative monetary policy on the one hand and investment brought forward by businesses making use of the 'super-deduction', intended to remain in place until the first quarter of 2023, on the other hand. As pandemic-related government support is being withdrawn, we anticipate GDP growth to slow to 5.0% in 2022. We continue to see downside risks linked to possibly longer lasting supply challenges and getting to grips with the post-Brexit trade regime.

Bank of England hesitant to raise interest rates

Averaging only 0.9% in 2020, the inflation rate surged to 4.2% in October 2021, well above the Bank of England's 2% target, pushed up by rebounding demand, supply shortages and high energy prices. The rate could reach an even higher level by spring next year, possibly moving around 5%, but the Monetary Policy Committee (MPC) highlighted the likely temporary character of these developments and, at its November meeting, refrained from announcing a first interest rate hike, despite increasing its inflation projections, and somewhat contrary to market expectations. The MPC currently expects inflation to be close to its target in two years' time, but signals necessary increases of its monetary policy rate over coming months in order to achieve this.

Reasons that prevented a majority of the nine-member committee (7:2) from voting in favor of a rate hike at this point in time was a lack of insight on how the labor market is digesting the end of the furlough scheme, as well as concern over the recent loss of growth momentum. A majority of 6:3 voted to continue with the existing program of government bond purchases, maintaining the target for the stock of these bond purchases at GBP 875bn and so the total target stock of asset purchases at EUR 895bn. The vote to maintain the stock of sterling non-financial investment-grade corporate bond purchases at GBP 20bn was unanimous.

We expect a first rate increase to occur in early 2022, which may be followed by further hikes to 0.75% by

the end of next year, from the current record low level at 0.1%. Reducing the government bond holdings is likely to occur in parallel.

UK house price dynamics have increased, irrespective of the expiry of a transaction tax break at the end of September. The HM Land Registry's UK house price index rose by 11.8% y-o-y in September 2021, although these results are currently subject to higher volatility, as the authority points out. Dampening effects from the expired tax regulation may still kick in. At the same time, demand for properties with outside space is likely to stay high for the time being, but may be tamed somewhat by less favorable financing conditions amid a turning tide of monetary policy and uncertainty over labor market developments.

Figure 16: Our real GDP forecasts mirror expectations of a solid recovery, but are revised down due to significant headwinds in the near term

In %, IMF forecasts for World, China, US

	2010-19	2019	2020	2021e	2022e	2023e
World	3,7	2,8	-3,1	5,9	4,9	3,6
Euro area	1,4	1,6	-6,4	4,9	4,4	2,3
Germany	2,0	1,1	-4,6	2,7	4,5	1,8
France	1,4	1,8	-7,9	6,7	4,1	2,2
Italy	0,3	0,4	-8,9	6,2	4,2	2,1
Spain	1,1	2,1	-10,8	4,4	5,6	4,1
UK	2,0	1,7	-9,7	6,8	5,0	1,6
US	2,3	2,3	-3,4	6,0	5,2	2,2
China	7,7	6,0	2,3	8,0	5,6	5,3

Sources: Creditreform Rating, IMF

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