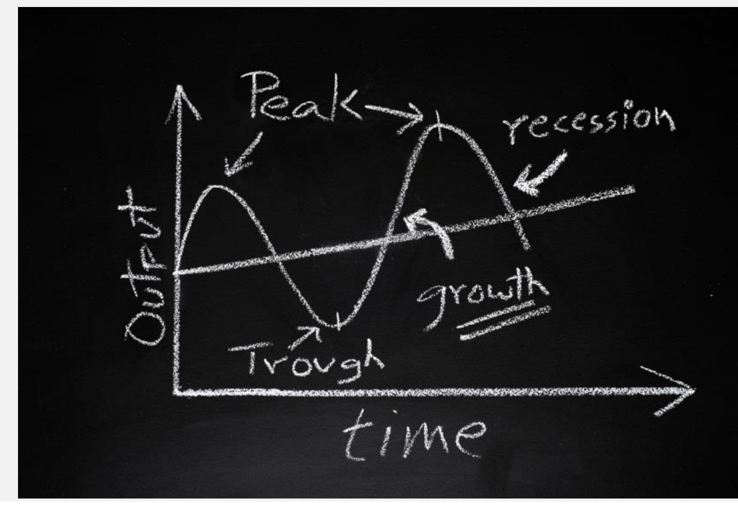
Creditreform
Rating

## Creditreform Economic Briefs

# Heading for recession




November 2022

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## KEY TAKE-AWAYS

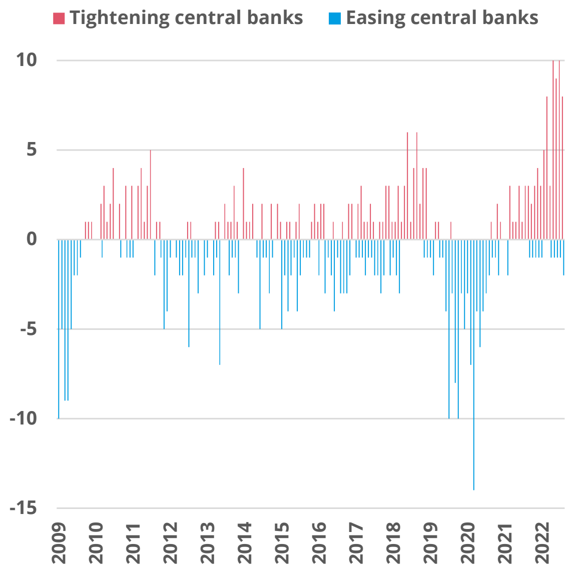
1. We forecast the **euro area's** real GDP to rise by 3.2% in 2022, with a lot of tailwind from a positive carry-over effects and with generous government support to alleviate the wider economic fallout from Russia's invasion of Ukraine. Under the assumption of weak domestic demand coupled with an only modest addition via the external side, we expect the euro area economy to virtually stagnate in 2023 (+0.2%). We believe that larger exposure to **tourism** should act as a stabilizing factor for some euro area members.
2. While **German** economic growth has been mainly driven by private consumption over the summer months, there may be a grim winter season ahead, with the German economy likely experiencing a technical recession. For the whole year 2023, we expect German real GDP to decline marginally by 0.1%, coming on the heels of positive growth to the tune of 1.7% in 2022.
3. German efforts to save **natural gas** appear to pay off at this stage, as current gas storage levels illustrate, delivering encouraging signs that at least the immediate winter season may be overcome without major disruptions. Against the backdrop of significant headwinds from high energy costs and a challenging external environment potentially weighing on the export performance, we expect the number of **insolvencies** in Germany to rise over the coming months. However, government support to alleviate energy costs should again prevent any dramatic increases.
4. **Inflation** rates remain high over the coming months in Germany and the euro area, but might see some moderation in 2023. We expect the **ECB** to hike its policy rates by another 50bp by the end of the year and continue with the somewhat slower pace in the first half of 2023. We expect shrinking of the ECB's balance sheet to start in the course of 2023.
5. Given tighter market funding conditions, recently vivid **house price** increases in the euro area and in Germany should soften. Banking sectors with large mortgage portfolios and higher exposure to variable-rate **mortgages** may have to be monitored more closely. A high share of cancellations regarding residential construction projects in Germany is receding only gradually. There may be more woes ahead for a rising number of construction businesses, as the share of those reporting financing constraints has gone up.
6. While we expect a significant slowdown for the **US** economy, a decline in GDP should be avoided. In light of a tight labor market and broad-based price pressure, we expect the **Federal Reserve** to continue hiking its policy rate, but to opt for somewhat smaller steps. Measured against the Fed's latest projections, we thus expect the federal funds rate to peak above the 4.6% median rate anticipated by the FOMC for 2023.
7. In a politically turbulent year featuring three prime ministers within just a few months, the **UK** economy lost its momentum. Real GDP is likely to decline in 2023, as domestic demand looks set to fall compared to 2022. For the whole year 2022, we currently project real GDP to expand by 4.2% and to fall by about 0.9% in 2023. Over the course of 2023, the upward pressure on CPI inflation should diminish gradually. The **Bank of England** maintains a tightening bias in view of double-digit inflation rates and persistent price pressure, despite increasing signs of the UK economy being in recession. With a view to 12 months' time, we project the policy rate to be raised to 4.25%.

# 1. World

As the highly challenging year 2022 is slowly drawing to a close, global economic prospects remain depressed by a number of risk factors. These include ongoing high commodity prices in connection with the war in Ukraine, multi-decade high inflation rates and tightening financial market conditions as an increasing number of central banks, in particular major central banks, front-load interest rate hikes to prevent inflation expectations from becoming de-anchored (see Figure **1**).

Figure 1: Central banks partly caught on the wrong foot by vigor of inflationary developments

Number of tightening vs. easing central banks worldwide




Sources: IMF, Creditreform Rating

Risks related to the coronavirus seem more remote by now, with scarring effects appearing by and large limited amid advanced economies, whereas risks around Russia's invasion of Ukraine and the consequences of the commodity price shocks and government support to alleviate the consequences have taken center stage. Supply bottlenecks of a number of materials have partly continued, not least as China has adhered to its zero-Covid-strategy.

About thirty countries, combined accounting for about a third of the global GDP, are likely to experience two consecutive quarters of contracting real GDP over 2022 and 2023, according to the latest IMF World Economic Outlook (Oct-22), hence witness a technical recession.

Overall, the IMF currently expects global GDP growth to decrease from 6.0% in 2021 to 3.2% in 2022 and further to 2.7% in 2023, maintaining its forecast for 2022 while further reducing its projection for the coming year (-0.2 p.p.) compared to its July 2022 forecast. It also slashed its forecast concerning global trade volumes by 0.7 p.p. to 2.5% for 2023, well below the average of 3.2% recorded over the pre-pandemic years 2015-19.

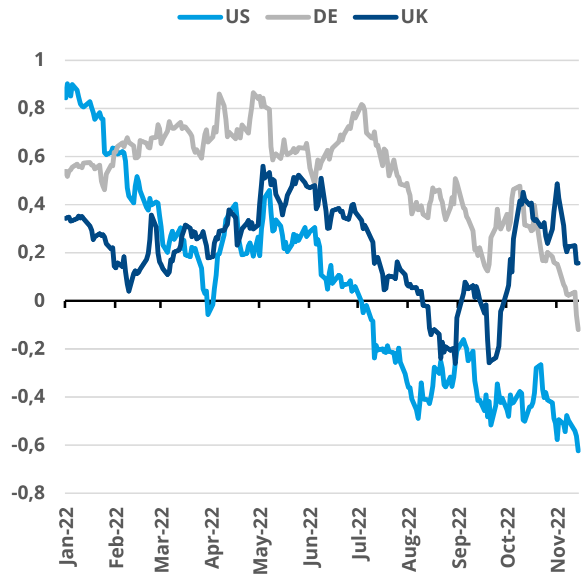
Amid generally higher public debt ratios following the corona crisis, governments have yet again opened the fiscal taps to cushion the most adverse effects from higher energy and food prices on society and businesses, partly raising concerns that fiscal stimulus might undermine intended dis-inflationary effects of monetary policy.

Financial markets have resumed to differentiate to a larger degree between sovereigns with more fiscal room for manoeuever and those displaying less thereof. As the major central banks' tightening cycle is in full flow, financial markets participants also appear to pay more attention to potential contradictions of fiscal versus monetary policies in an environment characterized by a higher public debt level, as e.g. the UK had to discover more recently.

Moreover, with the Federal Reserve running well ahead of the European Central Bank (ECB) and a number of other central banks regarding its - overall more aggressive than previously expected - tightening cycle, some other currencies including the euro have weakened markedly against the US dollar, adding to inflationary pressure at home and complicating finding an adequate response. Another effect of the Fed's perceived aggressive tightening is emerging recession fears on financial markets (see Figure **2**).

Figure 2: US bond yields signal recession ahead

Spread between 10-year and 2-year government bond yields, percentage points




Sources: Refinitiv, Creditreform Rating

*US: Significant growth slowdown next year, with an annual GDP decline likely being avoided*

After some rebound in this year's third quarter in terms of quarter-on-quarter GDP growth rates, dynamics in the US seem set to decrease again. Key leading indicators such as the ISM index for the manufacturing sector have clouded, with the ISM index falling to 50.2 points in October 2022, still in expansionary territory, but marking the lowest reading since May 2020.

While currently still acting as an important supportive pillar given ongoing tightness of the labor market and rapid and broad-based wage growth, private consumption should soften going forward, given high inflation rates and recent rigorous monetary policy tightening. Consumer confidence has been trending down over recent months. Fixed investment is likely to decline this year and next, with housing investment already shrinking on a q-o-q basis. In light of prospectively further slowing domestic demand, net exports could contribute positively to GDP growth next year, being on course to pose a drag to the expansion of economic output in 2022.

Having risen by 5.7% last year, the IMF expects the US' real GDP to slow to 1.6% this year and to drop to about 1.0% of GDP in 2023. Based on its latest projections from September 2022, the Federal Open Market Committee (FOMC) had been more pessimistic regarding the current year, with the median forecast at just 0.2% for 2022, while being somewhat more optimistic for the following years (2023: 1.2% in 2023).

Beyond next year, a more constructive growth outlook would be supported by an assumed end to monetary policy tightening, or possibly some reversal thereof, as well as by legislation passed in summer 2022 to foster the green transition as well as encourage R&D in critical high-tech sectors. With regard to the latter, the CHIPS and Science Act, which comes with an investment price tag of roughly USD 280bn over 2022-26, also incentivizes domestic production of semiconductors.

Likewise spread over several years, the government's Inflation Reduction Act (IRA) passed by the Congress in August 2022, will likely see rather limited effects in the short term. While the Act includes a reform to lower prices for prescription drugs, aiming at more vulnerable parts of society, it puts high emphasis on incentivizing the expansion of renewable energy. Moreover, the tax reform embedded in the IRA is likely to raise government revenue, among other things by introducing a minimum corporate tax rate of 15% for companies reporting profits in excess of USD 1bn. The IRA should thus also assist in reining in the US headline deficit.

US headline inflation (All Urban Consumers, CPI-U) has eased somewhat from recent highs, standing at 7.7% in October 2022, with the core rate (excluding food and energy) at an elevated 6.3%. This adds to expectations that the Federal Reserve will continue to raise interest rates, given that the unemployment rate has remained near historical lows, posting at only 3.7% in October 2022.

Having raised its key policy rate by a fourth consecutive 75-basis point step at its November monetary policy meeting after previous smaller hikes, the federal funds rate was lifted to a target range of 3.75-4.00%, from 0-0.25% at the beginning of 2022. Looking ahead, the FOMC might opt for somewhat smaller steps, stressing that when determining the pace of future increases, cumulative tightening of monetary policy will be taken into account, among other things. However, Governor Powell also hinted that the ultimate level of interest rates could be higher than previously expected. Measured against the projections presented in September, we thus expect the federal funds rate to peak above the 4.6% (median) anticipated by the FOMC for 2023.

*China: Muted economic performance coming on the back of costly lockdowns and simmering property market woes*

With regard to the Chinese economy, which remains hampered to an extent by repeated large-scale lockdowns due to restrictive Covid-19 polices, the GDP expansion rate could more than halve from 8.1% last year to about 3.2% this year (IMF forecast, Oct-22). Drawing on the Purchasing Manager Indices in October, which have been in contractionary territory - in the case of the manufacturing sector for a third consecutive month – current sentiment indicators back expectations of a somewhat subdued economic development for the time being.

Ongoing weakness in the property sector continues to weigh on the country's economic growth performance, with potential spillovers to private consumption as well as the banking sector and the wider financial system constituting a risk scenario. Notwithstanding fiscal support, this situation also seems to hamper investment growth at this stage. Reportedly, financial institutions were told by the regulator to provide further support to property developers. A number of projects have thus been put on hold, with mortgage takers wishing to buy property apparently asking for loan moratoria. For 2023, the IMF expects Chinese GDP growth to experience a moderate acceleration to 4.4%.

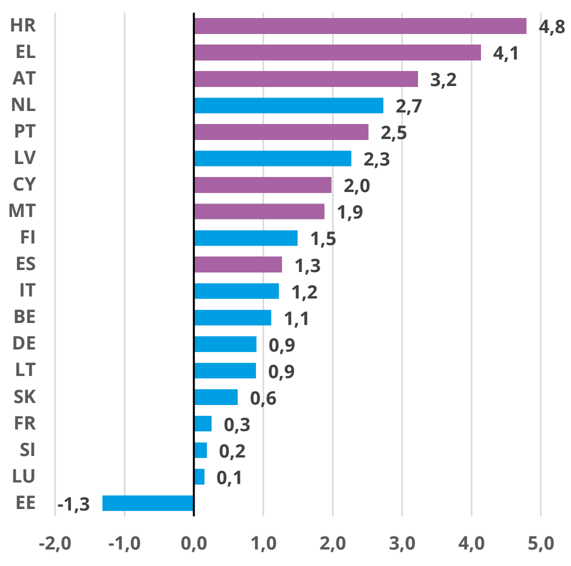
## 2. Euro area

*Recovering tourism cushions the drag entailed by the energy price shock*

Despite considerable headwinds from soaring commodity prices and supply shortages for a number of materials and products, economic developments in the euro area held up better than expected lately, with real GDP continuing to grow in the third quarter, albeit at a slower pace. Following healthy quarterly rates of 0.6% and 0.8% q-o-q in the first two quarters of 2022, economic output expanded by 0.2% in Q3-22, with Italy posting the strongest expansion (0.5% q-o-q) among the four largest euro area economies.

Figure 3: From curse to blessing: Tourism economies receiving tailwinds

Percentage change in real GDP, Q3-22 vs. Q4-21



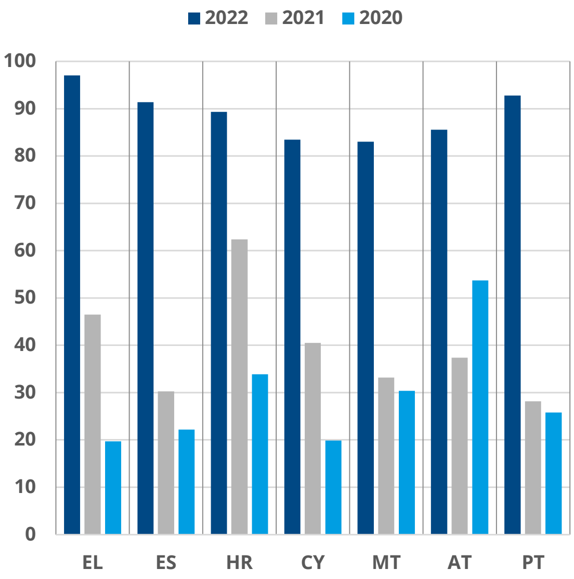

Sources: Eurostat, Creditreform Rating

More generally, it appears that larger exposure to tourism, which during the pandemic acted as a liability, has partly turned to a stabilizing factor for some countries in the current phase, as tourism is on the mend given ebbing pandemic risks (see Figure 3). Set against the fourth quarter of 2021, hence prior to Russia's invasion of Ukraine and the related massive

leap in commodity prices, a number of countries highly dependent on tourism, such as Croatia, which from 2023 will be the 20th member country of the euro area, Greece, Austria and Portugal display a comparatively strong growth performance (see Figure **4**).

Figure 4: Travelers unleashed – prime tourism destinations on their way back to normal

Tourist arrivals between January and September (CY: Jan to Aug), 2019=100



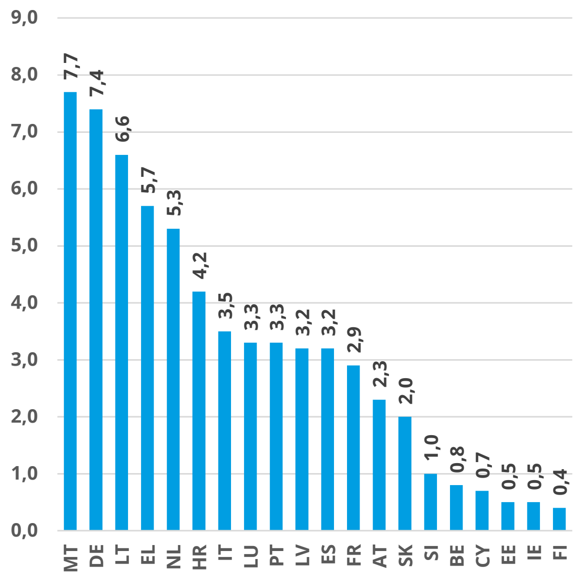

Sources: Eurostat, Creditreform Rating

That said, dependency on Russian energy imports and national policies to shield consumers and businesses from adverse (price) effects linked to the war in Ukraine certainly plays a crucial role, with e.g. Portugal featuring a low degree of dependency on Russian energy commodities, recovering tourism and introduction of caps on wholesale electricity prices.

In light of the burden presented by high commodity prices and rising inflation more generally, consumer confidence has dropped. In tandem with increasing borrowing rates on the back of the ECB's hiking cycle, we expect private consumption growth to decrease next year, after shaping up to be the major driver for GDP growth in 2022. However, extensive government measures to cushion the negative price effects on consumers, along with strong labor market developments and likely increasing upward pressure on wages should limit downside risks to household expenditure (see Figure **5**).

Figure 5: Significant support to shield European households and businesses from high energy costs

Euro area governments' earmarked and allocated funding to counter the energy crisis (Sep-21- Oct-22), in % GDP




Sources: Bruegel, Creditreform Rating

The labor market has continued to improve, albeit at a slower rate. Euro area unemployment stood at 6.6% in September 2022, having edged further down from 7.0% at the end of 2021. At the same time, the job vacancy rate has continued to climb over the last two years, standing at 3.2 as of Q2-22 and underscoring robust demand for labor. Labor shortages, in fact, are a pressing issue for European businesses, judging by recent surveys provided by the European Commission, remaining more pronounced in the service sector than in the manufacturing sector.

Investment may well be more affected by the adverse reverberations from current geopolitical events and reactions on the part of monetary policy,

given the high level of uncertainty, tightening conditions on financial markets and disrupted supply chains. While shortages of material and equipment remain elevated, but have showed signs of easing, important gauges for the sentiment among businesses point to more muted economic activity in the near term, likely weighing on fixed investment growth for 2023 as a whole. The Composite Purchasing Managers' Index (PMI) for the euro area recorded a fourth consecutive monthly decline in October. At 47.3 points, the indicator remains well below the 50-points mark typically associated with expansionary economic activity.

Export expectations have clouded as well since summer, suggesting that any growth contribution from net exports will likely remain rather small next year, after delivering an assumed moderately positive effect in 2022. Against the backdrop of fiscal assistance to private households and businesses, alongside support to refugees from the war in Ukraine, public consumption should deliver a positive contribution to GDP growth this year and next.

*Euro area GDP forecasts revised downwards, although fiscal support likely to prevent worse*

Overall, we expect the euro area GDP to increase by about 3.2% in 2022, with a lot of tailwind from a positive carry-over effect to the tune of 2.0 p.p. and with more or less generous government support to alleviate the wider economic fallout from Russia's hostilities in Ukraine (see above). For the coming year, under the assumption of weak domestic demand coupled with an only modest addition via the external side, we currently expect GDP to register only very little growth, to the tune of about 0.2%.

Having said that, price pressure could start to moderate in the course of next year, at least due to base effects, while efforts of European countries to further reduce dependency of energy commodity imports from Russia will continue. Likewise, diversification to other energy sources, in particular renewables, but also nuclear energy and others, will carry on.

Funding via NextGenerationEU will most likely continue to play a stabilizing role for GDP growth over this critical phase and the next few years, fostering greener growth and the digital transformation, albeit dependent on recipients' meeting agreed targets and milestones. In addition, efforts to build capacities to domestically produce key parts such as batteries, semiconductors and chips, which have been subject to supply shortages, are progressing. Prospects for medium-term growth thus remain buttressed by advancing implementation of initiatives and measures set out in the respective national Recovery and Resilience Plans to pursue the twin transition.

Risks to our growth forecasts are heavily tilted to the downside, stemming from a possibly more persistent high-inflation environment, also as it may take longer to find alternative and reliable energy suppliers or as this may only happen at a higher cost. Potentially, having to shift priorities may result in delay of envisaged measures included in the National Recovery and Resilience Programs. In case of a possible further escalation of the tensions with Russia, the medium-term outlook could also deteriorate. More generally, a lower degree of cooperation on critical issues such as energy supply, as well as on the shift towards more extensive use of renewables, could cloud the medium-to-longer term outlook for the euro area.

*Energy and food remain major drivers of inflation, but prices rise on an increasingly broader base*

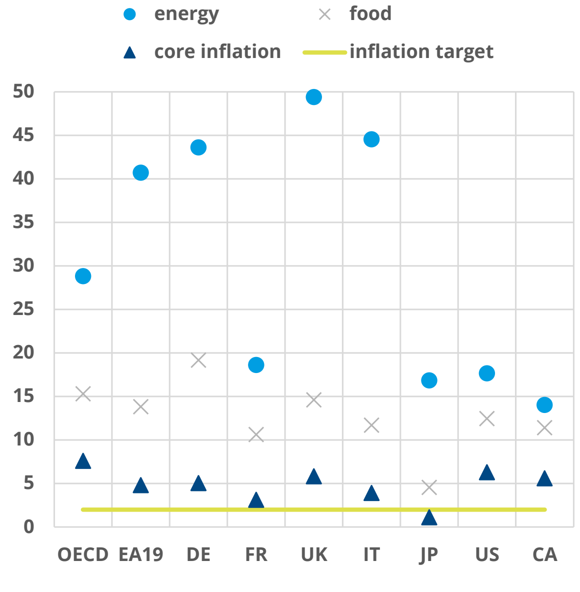
The inflation rate, meanwhile, has risen to 10.6% in October 2022, from an average of 2.6% in 2021. While prices for energy and food remain the major drivers (see Figure **6**), upward pressure is increasingly broad-based, as reflected by a climbing core inflation rate (excluding energy, food, alcohol and tobacco), which reached 5.0% in October (average 2021: 1.5%).

Looking at the euro area members, central and eastern European countries (CEE) continue to display the highest inflation rates, with Estonia on top of the list (Oct-22: 22.5%), not least as their respective price

baskets exhibit higher weights of both energy and food. Since Ukraine and Russia are major exporters of agricultural commodities, the war and the related blockage of respective exports via the Black Sea maintain upward pressure on food prices. In this context, following-through on the recently agreed extension of the grain deal by four months between Russia and Ukraine remains vital not only to ensure supply but also to contain prices. However, core inflation in the CEE countries remains higher than elsewhere in the EU as well, partly moving in double-digit territory.

Figure 6: Increasingly broad-based price pressure resulting in growing risks of de-anchoring inflation expectations

Selected annual HICP price increases, in %




Sources: OECD, Creditreform Rating

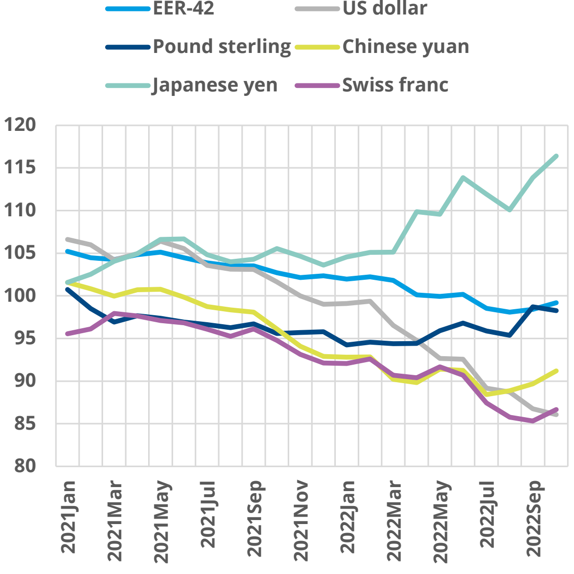
*Monetary policy unchained: ECB hits the accelerator to rein in inflation expectations*

Given the persistent price pressure and its broadening tendency, the ECB has embarked on a more aggressive monetary policy approach than initially expected, front-loading its monetary tightening in order to prevent de-anchoring inflation expectations. It has to be highlighted that the concept of forward guidance has been given up, with monetary policy decisions becoming increasingly data dependent.

In its September macroeconomic projections, the ECB has revised its HICP inflation projections considerably upwards, now averaging 8.1% in 2022, before moderating to 5.5% in 2023 and further to 2.3% in 2024, thus eventually converging towards the ECB's inflation target of 2%. Projections for the HICP excluding food and energy have been revised up for 2022 and 2023, too, with these remaining well above the 2% target for headline inflation as well, signaling underlying price pressure. Adding to price pressure, the euro has weakened considerably against the dollar, and more broadly against the currencies of 42 trading partners, as suggested by the respective index compiled by the ECB (see Figure 7).

Figure 7: Euro weakening against major currencies except for Japanese Yen

Euro vs. CHF, RMB, GBP, JPY and USD, spot prices, and nominal effective exchange rate against 42 trading partners




Sources: ECB, Creditreform Rating

The ECB raised its policy rates by another 75bp at its October meeting, lifting the total amount of increases to 200bp since the start of the rate tightening cycle this July. We assume that the ECB will hike

its policy rates by another 50bp by the end of the year and continue with a somewhat slower pace in the first half of 2023.

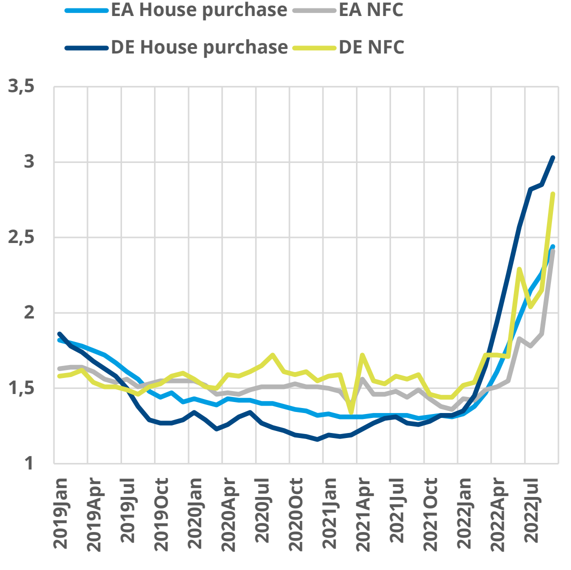
For the time being, the Governing Council intends to continue reinvesting the principal payments from maturing securities purchased under the Asset Purchase Program (APP) for as long as deemed necessary, and the principal payments from maturing securities purchased under the Pandemic Emergency Purchase Program (PEPP) until at least the end of 2024. We expect shrinking of the ECB's balance sheet to start in the course of 2023, but this issue will likely be discussed at the upcoming monetary policy meeting in December.

*A different set of financial stability risks coming to the forefront*

Given tighter market funding conditions, recently vivid house price increases should soften. Banking sectors with large mortgage portfolios and higher exposure to variable-rate mortgages may have to be monitored more closely, with macroprudential policies to play a more prominent role (see Figure 8).

Figure 8: Tightening borrowing conditions likely to slow housing market activities

Lending rates for house purchase and NFC loans, euro area (EA) and Germany (DE), in %



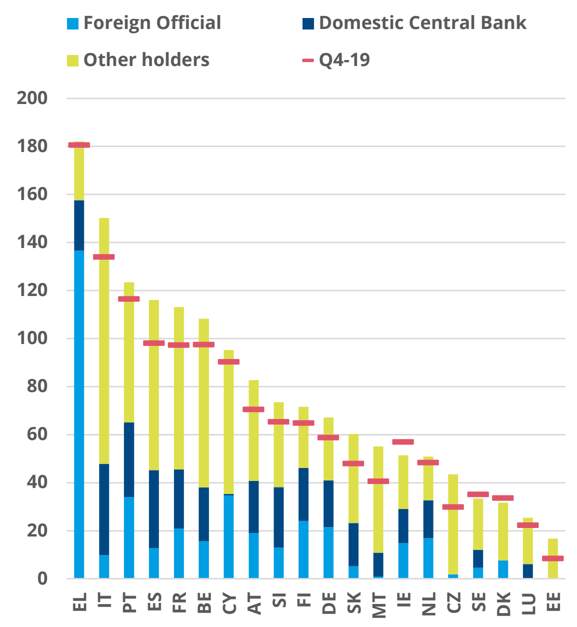

Sources: ECB, Creditreform Rating

More generally, asset quality may eventually start to deteriorate going forward, having weathered the pandemic rather well, partly thanks to application of moratoria and special regulation. Apart from that, progressing digitalization will increase risk of cyber-attacks, a risk that has become even more accentuated in the current geopolitical context. Recent insolvencies in the context of crypto assets underscore that, amid high energy costs and potentially more attractive investment alternatives in a rising interest-rate environment, fintech solutions come with their own risks.

In light of higher public debt ratios following the recent succession of crises (see Figure 9), the EU fiscal framework is once more under scrutiny for a larger overhaul. While the general escape clause with regard to the fiscal rules under the EU's Stability and Growth Pact will remain in place for 2023, the European Commission published reform proposals for the wider governance framework this November.

Figure 9: Fiscal risks seem to be more contained where the official sector holds larger shares of sovereign's public debt

General government debt-to-GDP ratios as of Q2-22, breakdown by holders of debt




Sources: Eurostat, IMF, Creditreform Rating

Apart from debt sustainability, higher emphasis is to be put on sustainable growth. With regard to the fiscal framework, main goals are to achieve a higher level of national ownership regarding their medium-term fiscal-structural plan, an overall simplification of macro-fiscal surveillance and a strengthening of enforcement of disciplining measures.

## 3. Germany

*Brace yourself: Winter is coming*

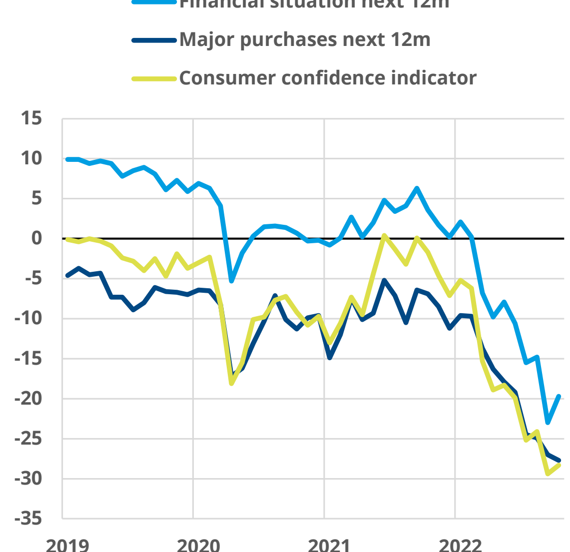
As in the euro area as a whole, Germany's real GDP kept expanding in the third quarter, posting a moderate increase of 0.3% q-o-q after near-stagnation in spring. With that, the German economy proved somewhat more resilient than expected and finally exceeded its pre-pandemic level (Q4-19), although lagging somewhat behind the euro area as a whole in this respect.

Economic growth has been mainly driven by private consumption over the summer months. Looking at recent sentiment indicators, however, there may be a grim winter season ahead (see Figure **10**). Since Russia's invasion of Ukraine, important sentiment gauges such as the GfK consumer climate, as well as the ifo business climate index and the PMIs have been trending downwards, just as consumer price inflation has been creeping up. For a second consecutive month, HICP inflation was in double-digits, reaching 11.6% in October 2022, also on the back of imported inflation, added to by the euro's depreciation against many currencies since the onset of the war in Ukraine (see above).

Although wage growth was comparatively strong of late, averaging 5% y-o-y in the first half of 2022, and is set to increase further amidst ongoing labor shortages, real wages will remain in negative territory in the near term, given brisk consumer price inflation. The recent wage deal agreed for Germany's metal and electrical sector, resulting in a pay rise by 5.2% from June 2023 and by a further 3.3% from May 2024 may serve as a blueprint for upcoming negotiations in other sectors. Average wages are also boosted by a second leap in the statutory minimum wage this year, to 12 euro per hour from October 2022, from 9.82 euro at the beginning of 2022. We note that the strong rise is supposed to be a one-off.

Figure 10: German consumers' cutting back on spending plans bodes ill for private consumption

Consumer confidence indicators, balances




Sources: Eurostat, Creditreform Rating

To limit economic fallout from the Russian war against Ukraine, the German government provided three support packages for households and businesses, amounting to an overall volume of about EUR 96bn in 2022 and 2023. Moreover, while wholesale gas prices have come down in the meantime, a mechanism to keep a lid on electricity and gas prices for private households is to be implemented in due course.

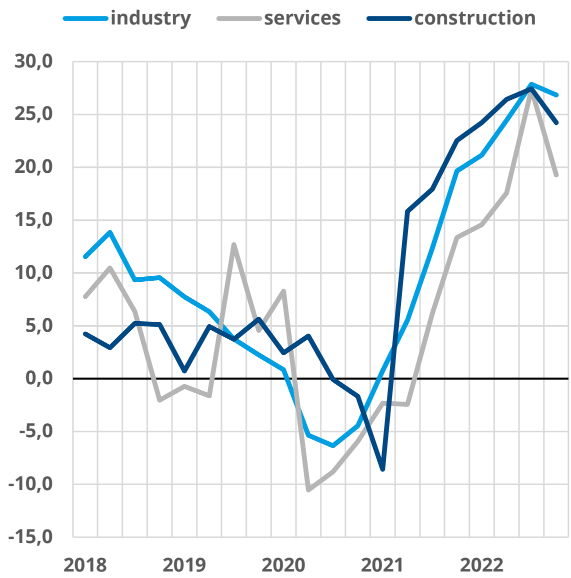
Potential further support to disposable income in the form of a welfare reform, with the introduction of the so-called 'Buergergeld' at its heart, could follow after a compromise was found between the governing coalition and the opposition over the concept.

The German labor market has continued its strong performance, with the unemployment rate remaining near historical lows at 3.0% in September 2022

(LFS-adjusted Eurostat data). Total employment has been above its pre-pandemic level from this year's first quarter, continuing to expand by Q3-22. However, drawing on the latest ifo employment barometer, hiring intentions have been on the decline throughout the second half of 2022, reflecting some caution on the part of businesses in the current uncertain environment. This is to be seen against ongoing difficulties to fill gaps in the labor market amid persistently reported labor shortages, leading us to expect an overall relatively stable employment level for 2023 (see **Figure 11**),

Figure 11: Finding skilled staff in Germany remains a challenge – potentially fueling wage demands

Share of survey respondents citing shortage of labor as a factor limiting production, deviation from long-term average (Q1-12 to Q4-21) in percentage points




Sources: Eurostat, Creditreform Rating

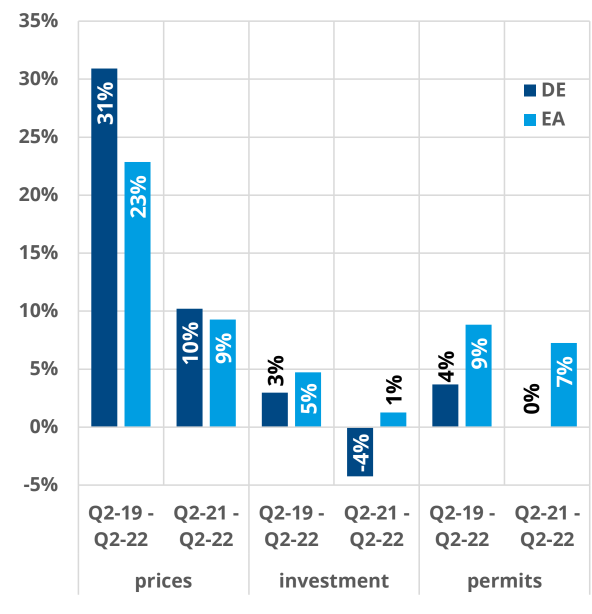
While private consumption will likely turn out as the key supporting pillar for 2022 GDP growth, we expect a decline of private household expenditure for 2023, mainly on the back of a likely weak winter season. This would be the case despite continued efforts by the government to cushion the adverse effects for consumers.

On the back of the current difficult environment paired with tighter financial market conditions, we also expect to see fixed investment decrease in 2023, after a likely modest expansion in 2022. While investment in machinery as well as intellectual property should have contributed positively to an overall increase of gross fixed capital formation, construction investment partly hampered by supply bottlenecks and exploding costs, is likely to turn out as a drag.

A high share of cancellations, mostly regarding residential construction projects (October 2022: 14.5%), but also in commercial and public building construction over recent months is only slightly receding, as the ifo institute found in October. With regard to 2023, there may be more woes ahead for a rising number of businesses in the construction sector, as the share of those reporting financing constraints has gone up from 0.6% to 6.6% in the year to October 2022 (see Figure **12**).

Figure 12: Momentum in housing appears to be slowing more recently

Residential property developments, cumulative growth (%)




Sources: Eurostat, Creditreform Rating

The outlook for the export-heavy German economy remains dampened by the burden placed on key European trading partners by high energy costs as well as deteriorating relations with China, with the latter battling with its homemade economic challenges, i.e. its zero-Covid strategy and the downturn on its real estate market (see above).

Looking at the production side, the stock of manufacturing orders declined significantly in September 2022, following an almost uninterrupted phase of increases between May 2020 and August 2022, when high demand for industrial products coincided with supply chain problems after the initial phase of the pandemic. New manufacturing orders have on trend declined over the last few months, while supply bottlenecks continue to persist, leaving the stock of unfilled orders still at a relatively high level.

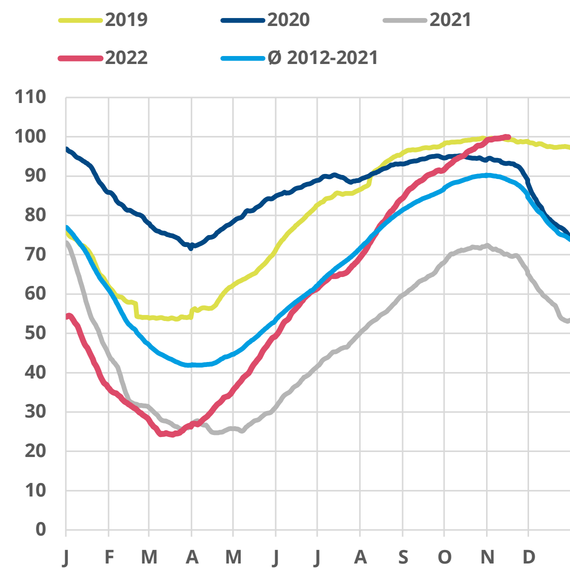
As compared to our last Economic Briefs, we now see a then-risk scenario materializing given Russia's halting of gas deliveries. Nevertheless, efforts to save natural gas/energy appear to pay off at this stage, added to by mild temperatures, as current gas storage levels illustrate, delivering encouraging signs that at least the immediate winter season may be overcome without major disruptions (see Figure **13**).

We expect the German GDP to post an increase of 1.7% this year on the back of domestic demand, whereas net exports seem set to take a considerable portion off GDP growth. For 2023, we pencil in a moderate contraction by 0.1%, with domestic demand being significantly impaired by the consequences of soaring commodity prices, the pronounced level of geopolitical uncertainty and less favorable financial market conditions.

The medium-term growth outlook remains constructive in our view, notwithstanding the challenges coming with having to find alternative energy suppliers and moving the economy further towards the use of renewables. Dependencies are also to be reduced with regard to materials and/or (intermediate) products essential for driving the digitalization.

Figure 13: Gas storage fillings at seasonally high level, suggesting hard rationing should be avoided this winter

Germany, gas storage filling level by month, in %



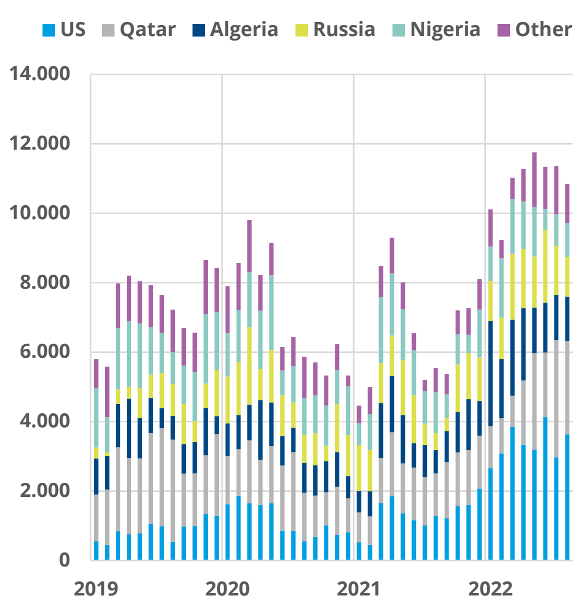

Sources: AGSI, Creditreform Rating

In this context, it is worth mentioning that a large producer of chips has announced the construction of a new production site in Saxony more recently, enhancing capacities in chips and semiconductor production, planned to be completed in 2026.

More immediate advancements are likely achieved with regard to the construction of an LNG terminal in Northern Germany, with potentially seven more terminals available and connected to the national gas grid by the end of 2023, possibly beating previous expectations. With Russia no longer a candidate to provide LNG, important suppliers such as the US, Qatar, and Nigeria are likely to gain significance going forward (see Figure **14**).

Figure 14: Dependency on Russian LNG imports likely to decline in the future

EU-27 imports of LNG, million cubic meters




Sources: Eurostat, Creditreform Rating

*Business insolvencies set to increase, albeit from very low levels*

Business insolvencies have continued to remain tame, following an exceptional phase during the pandemic, when various support schemes and special regulation was in place. October 2022 saw applications for insolvencies rise by 18.4% compared to the preceding month, when the number of applications was declining by a double-digit percentage (20.6%) by monthly comparison. Actual insolvencies, numbers of which usually come with a time lag, in August 2022 were 11.5% above their level in the preceding year, nevertheless not appearing excessive. Looking at the breakdown by sector, the often-observed pattern continued to hold, insofar as the construction sector witnessed the largest number of insolvencies. We expect the number of business bankruptcies to rise over the coming months, but government support to alleviate energy costs should again prevent any dramatic developments.

# 4. **United Kingdom**

*Grabbing the limelight in an unintentional way*

In a politically turbulent year featuring three prime ministers within just a few months, the UK economy lost its momentum displayed in the first quarter of 2022. Having expanded with a quarter-on-quarter rate of 0.7% in the first three months, GDP growth slowed to 0.2% in Q2-22 and contracted by 0.2% in Q3-22 according to preliminary estimates, partly due to the exceptional bank holiday for the state funeral of Queen Elizabeth II in September.

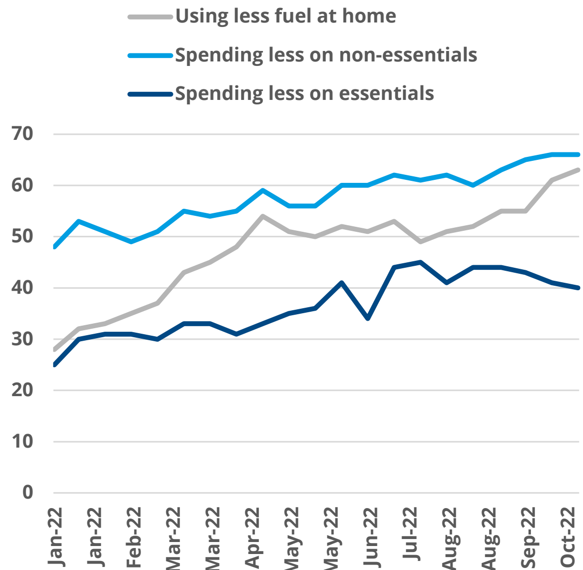
Moreover, according to the ONS data, the equivalent of more than 560 thousand workdays was lost due to strike action across industries in connection with higher wage demands in August and September combined, the highest fallout in over ten years. This left real GDP 0.4% below its pre-pandemic level (Q4-19).

In order to ease the burden from high energy costs for consumers and businesses, the government had announced an Energy Price Guarantee (EPG) and an Energy Bill Relief Scheme (EBRS) in September 2022, in effect from October 2022 and initially intended to run for six months. Some of this support is likely to last beyond this period. Given these guarantees, we think that increases in the CPI energy component should be limited going forward. The measures flank government support packages aimed to bring some relief to private households adding up to about GBP 37bn in the course of 2022.

High energy prices are weighing on household spending, as do high food prices, which in October 2022 recorded an increase by 16.4% y-o-y. The CPI inflation rate skyrocketed to a new multiple-decade high at 11.1%, leading to widespread dissatisfaction amid parts of society (see Figure **15**).

Figure 15: Rising cost of living forcing consumers to cut back

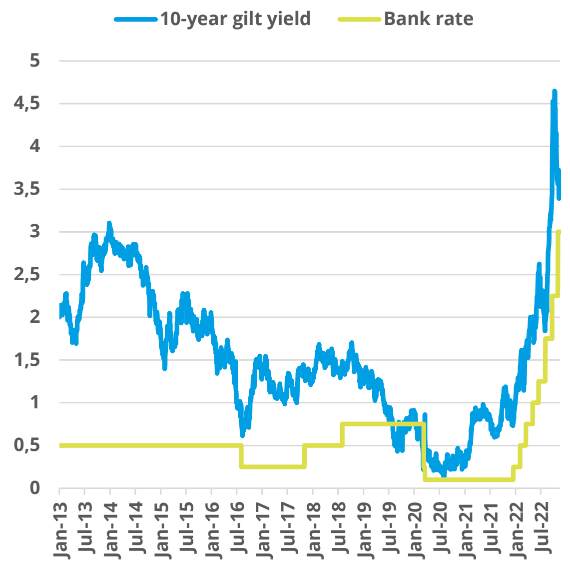
Responses to the ONS Opinions and Lifestyle Survey, share of respondents in %




Sources: ONS, Creditreform Rating

Figure 16: UK asset prices calming again after political reassurance and BoE intervention

10-year government bond yield and Bank rate, in %




Sources: Bank of England, Creditreform Rating

*Politics playing with fire – a tricky balancing act*

Largely owing to the 'mini budget' announced under previous prime minister Truss at the end of September, which had foreseen significant tax cuts while lacking detail on how this would be financed, UK asset prices underwent a turbulent phase, forcing the Bank of England to step in to stabilize financial markets (see below). 10-year bond yields surged against the backdrop of growing financial market concern over fiscal sustainability given the UK's increased debt level in the wake of the pandemic (see Figure **16**).

After less than two months in office, Liz Truss, who had followed Boris Johnson as prime minister after his resignation in July, stepped down as well. With Rishi Sunak taking over as head of the Conservative government in October, his finance minister reversed most of the announced tax cuts under the Truss government, emphasizing the need to rein in public finances while sticking with support to alleviate the burden from high energy costs.

With his Autumn Budget presented this November, the Chancellor of the Exchequer announced a GBP 26bn cost-of-living support package, including energy support. Businesses will be supported by a GBP 13.6bn package. To raise necessary funds, tax changes that will affect all taxpayers are to raise GBP 25bn by 2027/28, while from the financial year 2025/2026 spending is to increase more slowly. Previous plans to lift the main rate of corporation tax to 25% from April 2023 remain unchanged.

*Lackluster near-term outlook for domestic demand*

With the higher market yield curve pushing up rates for new mortgages, and with financial conditions generally having become tighter and likely to continue doing so for some time ahead, prospects for investment have weakened further, undermining tax incentives initially expected to boost capital formation until their expiry in Q1-23. The housing market seems set to experience a marked downturn in the face of latest developments.

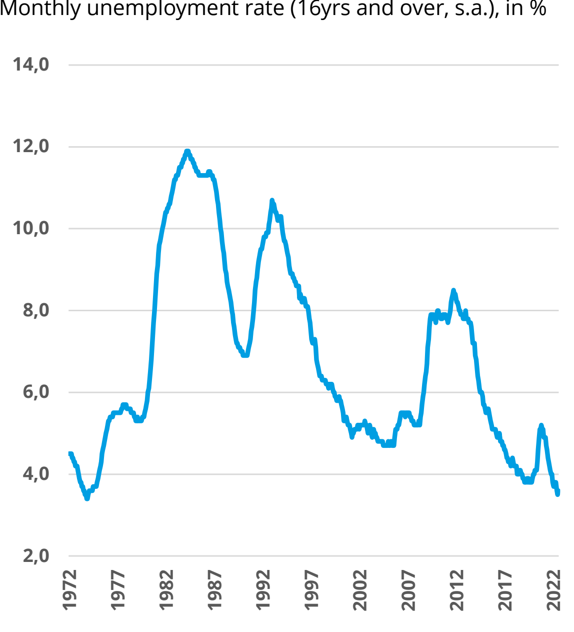
Sentiment indicators back the assumption of a clouding near-term outlook for domestic demand.

Consumer confidence is falling as private households feel the pinch from higher cost of living and higher cost of borrowing. Corporate sector sentiment has continued to weaken, with the manufacturing PMI deeper in contractionary territory and the service sector PMI dropping under the respective 50-point threshold in October.

For the whole year 2022, we currently project real GDP to expand by 4.2% and to fall by about 0.9% in 2023. Given the dim near-term prospects for domestic demand, net exports could deliver a positive growth contribution next year, although exports are unlikely to see a strong increase given the muted external environment and post-Brexit aches. Over the course of 2023, the upward pressure on CPI inflation should diminish gradually, assuming that commodity prices stabilize or start to reverse and the price cap on energy is showing its effect. Moreover, tighter than previously expected monetary policy combined with likely contracting domestic demand should ease more broad-based pressure on prices. On the other hand, sterling weakness could to some degree counteract these developments.

Figure 17: Jobless rate hitting a multi-decade low in 2022

Monthly unemployment rate (16yrs and over, s.a.), in %




Sources: ONS, Creditreform Rating

Looking at the labor market, the unemployment rate remains at a long-time low, posting at 3.5% in the three months to August, the lowest level since 1974 (see Figure **17**). At the same time, the ratio of vacancy to unemployment stays high, while there are a few signs that that demand for labor may be about to ebb somewhat. It is also noteworthy that there has been a higher number of inactive people, in particular in the 50-64 years age cohort.

### *Bank of England steps in to stabilize financial markets – but monetary policy tightening continues*

At the current juncture, the UK's labor market thus remains tight, adding fuel to the inflationary fire and contributing to the Bank of England raising its policy rate by 75 basis points in November 2022, to 3.0%, representing the eighths consecutive hike and the first large step since the rising cycle began in December 2021. While the Bank admits to considerable uncertainties around its economic outlook, a tightening bias remains in place. We currently expect the base rate to be raised to 4.25% in 12 months' time.

Looking at progress in terms of shrinking its balance sheet, the central bank's job had temporarily been made more challenging by the abovementioned episode of asset price turbulence. The latter prompted the Bank of England to carry out temporary purchases of long-dated UK government bonds from 28 September to 14 October 2022, amounting to GBP 19.3bn, in order to 'reduce any risks from contagion to credit conditions for UK households and businesses'.

Unaffected by this episode, the first Asset Purchase Facility (APF) gilt sales took place in November 2022, as had been set out in the regular monetary policy meeting in September 2022. Already in March 2022, the Bank of England had ceased reinvestment of maturing gilts, and from the end of September 2022, APF corporate bond sales have taken place. The Bank remains committed to shrinking its accumulated stock of purchased government bonds by GBP 80bn over 12 months as seen from September 2022, to a total of GBP 758bn. The emergency portfolio ac-

cumulated under the temporary and targeted purchases in September and October 2022 is to be wound down from 29 November 2022.

*Lingering issue of Northern Ireland protocol and Scottish referendum*

In terms of domestic political leadership, the UK has partly been in turmoil over 2022, but we ultimately do not see its political credibility damaged. Arguably, some reversal of previously surging UK bond yields echoes this assessment.

Early elections ahead of the regular election to be held in 2024 remain a remote scenario, and we continue to assume little change in terms of post-Brexit policies including the contested Northern Ireland protocol, with the position of the incumbent prime minister on this issue appearing somewhat vague at this point in time. With regard to a potential second Scottish referendum on independence, intended to be held by the Scottish National Party, the UK Supreme Court ruled in November that such a referendum could not be held without the UK government's consent.

Figure 18: Our forecasts have been revised downwards for 2023, reflecting ongoing woes surrounding inflationary pressures and supply-side shortages, exacerbated by the Russian war in Ukraine

In %, IMF forecasts for World, China, US

| | 2010-19 | 2020 | 2021 | 2022e | 2023e |
|---|---|---|---|---|---|
| **World** | 3,7 | -3,0 | 6,0 | 3,2 | 2,7 |
| **Euro area** | 1,4 | -6,1 | 5,3 | 3,2 | 0,2 |
| ***Germany*** | 2,0 | -3,7 | 2,6 | 1,7 | -0,1 |
| ***France*** | 1,4 | -7,8 | 6,8 | 2,5 | 0,3 |
| ***Italy*** | 0,3 | -9,0 | 6,7 | 3,8 | 0,2 |
| ***Spain*** | 1,1 | -11,3 | 5,5 | 4,6 | 0,9 |
| **UK** | 2,0 | -11,0 | -7,5 | 4,3 | -0,9 |
| **US** | 2,3 | -3,4 | 5,7 | 1,6 | 1,0 |
| **China** | 7,7 | 2,2 | 8,1 | 3,2 | 4,4 |

Sources: Creditreform Rating, IMF

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