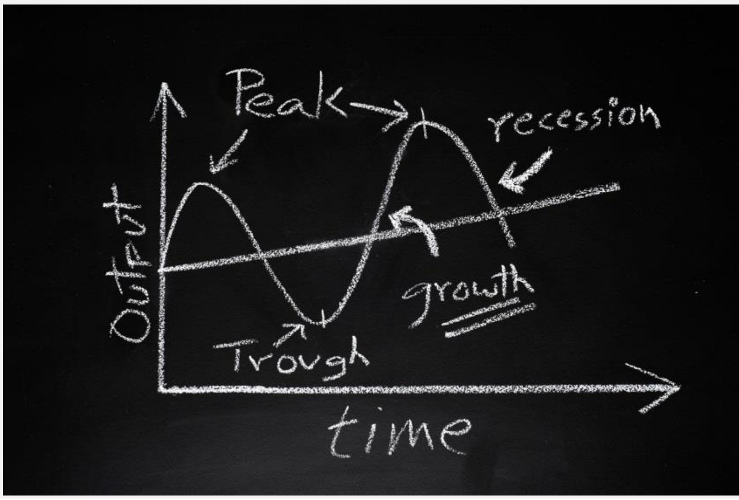
Creditreform Rating

Creditreform Economic Briefs

Not there yet – monetary policy tightening approaching peak



March 2023

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Key Take-aways

1. We forecast the **euro area's real GDP** to rise by 0.8% in 2023, which due to the economic weakness around the turn of the years 2022/2023 represents a significant slowdown compared to 2022, albeit a slight upward revision to our previous Economic Briefs. The **ECB's more forceful response** to high inflation rates than initially assumed is likely to show a greater dampening effect in 2024. We expect total economic output to expand by 1.4% next year, with moderate growth impulses from domestic demand and net exports alike.
2. While headline Inflation rates should continue to retreat, core inflation rates likely remain high over the coming months in Germany and the euro area. Despite the current market tensions over some financial institutions in the US and in Europe, we **still expect** the **ECB to raise its policy rates** by an overall 50bp by the end of the year. Rate cuts are unlikely to happen before 2024.
3. Despite cost pressure and interest on mortgages having remained high or rising, **house price dynamics** have barely softened, although more recent data may point to a greater impact taking hold. **Banking sectors** with large mortgage portfolios and higher exposure to variable-rate mortgages will certainly have to be monitored more closely. Macroprudential policies are being adjusted in a number of European economies. More generally, as can be observed in the US and in Europe, financial markets' and investors' tolerance towards **perceived deficiencies of financial institutions** is rapidly diminishing in the new interest rate environment.
4. **German economic growth** looks set to post a weaker growth result than the euro area overall this year, although a technical recession may still be avoided. Private consumption will likely remain affected by high prices for a broader range of products, while energy prices may continue their retreat seen over the last few months. The labor market situation should by and large remain supportive to household expenditure. Given the expected acceleration of Chinese economic growth, alongside the assumed moderate expansion of the European and US economy, prospects for German export growth have brightened somewhat. For the whole year 2023, we expect German real GDP to increase by 0.2%, followed by an acceleration to 1.4% in 2024.
5. In view of the constraints on both the domestic economy and the external environment, we expect **UK real GDP** to decrease by 0.4% in 2023. Adverse effects from tighter monetary policy on economic activity should further unfold, likely restricting growth dynamics in 2024. We forecast GDP growth of 0.9% for 2024, expecting a last policy rate hike by 25bp to 4.25% in March 2023 from the **Bank of England**. The so-called 'Windsor Framework', a political agreement in principle between the UK and the European Commission, could finally put an end to the dispute over the Northern Ireland Protocol.
6. While **US economic growth** has slowed down, the labor market remains very tight and price pressure broad-based, prompting the **Federal Reserve** to continue to hike its policy rate, although we think that the peak is approaching. We expect the federal funds rate to be lifted to 5.25-5.50% in 2023, and do not expect a first rate cut to occur until the first quarter of 2024 at the earliest.

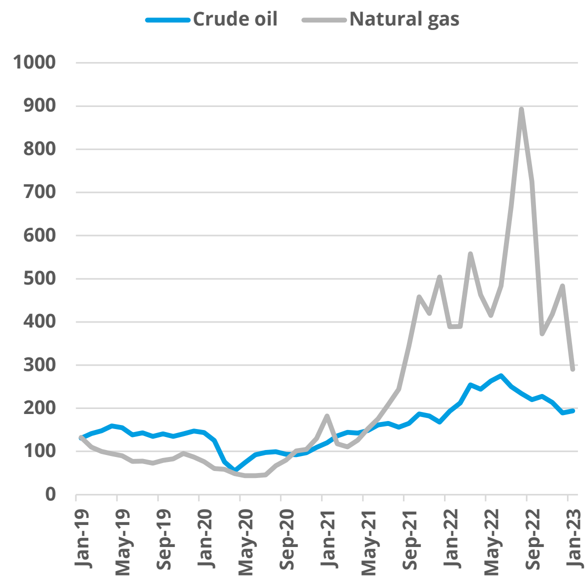
1. World

A few months into the year 2023, some of last year's risk factors have softened noticeably. At the end of the winter season in the Northern hemisphere, energy storage levels have largely proved sufficiently high, and Western countries particularly dependent on Russian energy imports have progressed on finding alternative energy suppliers.

Energy prices have dropped markedly over recent months (see Figure **1**), and ongoing government support to alleviate the burden of higher energy costs on private households and businesses has contributed to preventing technical recessions around the recent turn of the year in many advanced economies. However, this widely comes at the cost of higher public debt, partly from already elevated levels, in a capital market environment involving higher borrowing costs, as major central banks' fight against inflation continues.

Figure 1: Energy prices are on the retreat

Price index crude oil (2016 = 100) ⬄ average of Brent, WTI, Dubai Fateh; price index natural gas (2016=100) including European, Japanese, American gas price indices

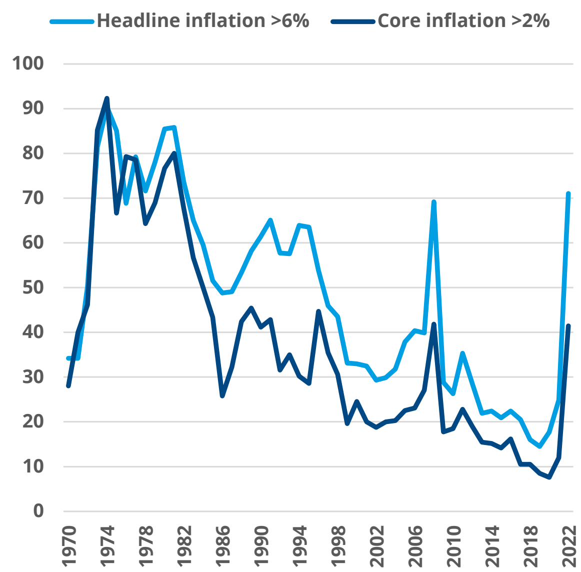


Sources: IMF, Creditreform Rating

Tying in with a less gloomy picture, the IMF slightly increased its global GDP forecast for the current year in its latest forecast dating from January 2023, to 2.9%, which due to a nevertheless weak economic phase over the winter season 2022/2023 represents a marked slowdown compared to global output growth in 2022 (3.4%). We note that the near-term economic outlook remains dampened by high inflation rates amid broadening prices pressure as service prices rise on the back of higher energy costs, adding to pressure from stiff competition for talent to drive the green and digital transformation as well as remaining post-Covid labor shortages in many industries (see Figure **2**).

Figure 2: Consumer price inflation in many countries increasing to highest levels in decades

Share of countries worldwide experiencing high headline/core inflation, in %

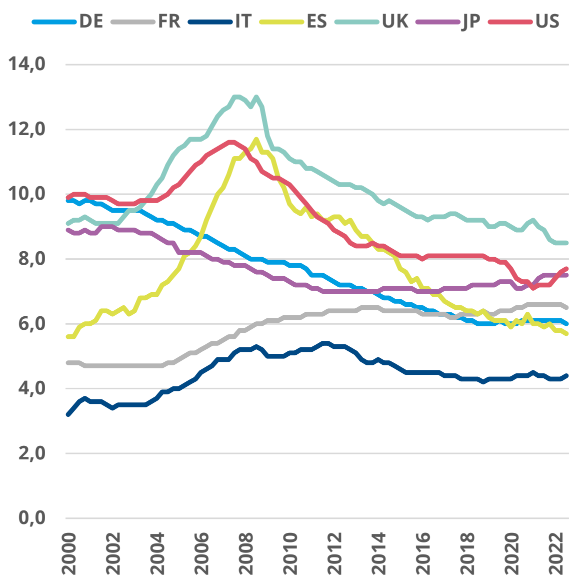


Sources: World Bank, Creditreform Rating

In response, major central banks have been pursuing a more aggressive monetary policy cycle than initially anticipated, in turn raising some market concerns over possibly driving policy tightening too far and pushing the economy into a deeper recession. While economic prospects are ultimately predicated on the war in Ukraine, we expect high inflation and repercussions of monetary policy tightening to weigh on household spending and fixed investment, dampening economic activity in the global economy this year and next. However, a risk scenario could involve a more protracted period of subdued or even shrinking private consumption and/or a longer phase of lackluster investment in view of partly stretched private sector balance sheets. To be sure, the ongoing pursuit of ambitious green and digital agendas, with positive knock-on effects as well as incentives for private investment, should provide some counterweight. In addition, and broadly speaking, debt servicing cost until recently do not seem to have reached threatening levels yet (see Figure **3**).

Figure 3: Debt service ratios do not point to imminent private sector credit risks in major economies

Debt service ratio (⇔ interest payments and amortizations to income) for the private non-financial sector

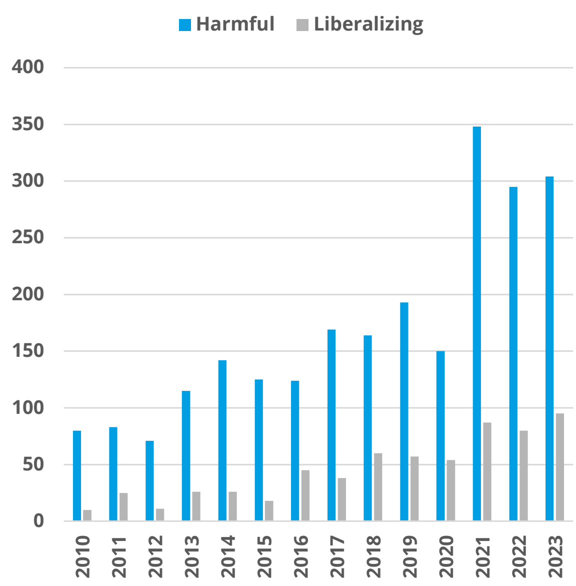


Sources: BIS, Creditreform Rating

Geopolitical tensions, which have been growing significantly over recent years, remain a key risk factor, essentially boding ill for international trade as well as a successful transition towards a green and digitalized global economy. While we think that Russia's invasion has fast-tracked the transition to renewables to some degree, international trade and global supply chains have been dealt a series of blows, be it by the Covid-19 pandemic or by Russia's military aggression against Ukraine. Intensifying tensions between the US and China over alleged spying attempts by China presumably mean a further backlash to global trade cooperation (see Figure **4**). With demand for commodities and intermediate products needed to advance the digital transformation ever increasing, supply bottlenecks remain a factor hampering economic activity in many areas, although a recent peak in reported shortages of materials and equipment has been overcome, certainly aided by China's altered strategy regarding Covid-19.

Figure 4: Trade policies as a harbinger for future constraints for international trade and frictions in global supply chains

Number of implemented global trade interventions per year, including trade-protection measures, subsidies, tariff measures



Sources: Global Trade Alert, Creditreform Rating

Recovering Chinese economy will provide some support to global economic growth this year

Indeed, China's less restrictive corona policy since the end of 2022 could enable a strong growth recovery this year, although a de facto tolerated higher number of corona infections will presumably impair economic activity to some extent. Following a relatively meagre increase by about 3.0% in 2022, the IMF expects China's total output to expand by 5.2% this year, which would be close to the relatively moderate 5% target for 2023 communicated during the recent National People's Congress. It is noteworthy that military spending is to be increased by 7.2%, higher than in the preceding few years. In light of a normalization following the reopening boost, 2024 could then see a slightly slower growth pace (IMF: 4.5%). Developments in the real estate sector remain a prominent downside risk to the economic performance, as mortgages, housing investment and real estate transaction continue to follow their firm downward trajectory, although economic policy support for the real estate sector has become more compressive. A larger scale of defaults by property developers would likely have adverse consequences for the banking sector and potentially the wider financial system.

As far as global GDP growth in 2024 is concerned, there remains good reason to curb expectations. With the initial energy price shock fading, broader-based price pressure and the robust countermeasures by major central banks are set to take their toll, likely restraining domestic demand, to which withdrawing of government support will likely contribute. According to the IMF, global economic output will expand by about 3.1% next year, with the risk balance likely still tilted to the downside. At this stage, we do not expect a first rate cut in 2023 by major central banks such as the US Fed, the Bank of England and the ECB.

In the United States, peak tightening is coming in sight

Since starting its hiking cycle one year ago, in March 2022, the US Federal Reserve has lifted its main policy rate by 4.5 percentage points, to a range of 4.50%-4.75% at the beginning of February 2023, with the pace having been reduced more recently, as illustrated by the 25 basis point hike this February. Nevertheless, the Fed's monetary policy committee (FOMC) hinted at further increases to come, due to insufficient confidence over a firm downward path of inflation over the medium term, despite signs of moderating economic growth. Supposedly having reached a phase of fine-tuning from February, the slower hiking pace may turn out to be somewhat premature, given comments by Governor Powell and other FOMC members in March, suggesting that peak tightening seems not as close as markets assumed in February.

The more aggressive tightening cycle and associated financial market developments also bring to the fore risks related to asset/liability mismatches, which have played a crucial role in the recent demise of the Californian Silicon Valley Bank alongside more specific factors. Upon the resolution of the bank, the Federal Deposit Insurance Corporation and the Federal Reserve in a joint statement with the Secretary of the US Treasury reassured depositors of the bank over access to all of their money.

In its most recent projections, dating from December 2022, the FOMC had anticipated PCE inflation to peak in 2022, expecting to bring it close to the 2%-target in 2025. The Fed funds rate was anticipated to reach its top at 5.00-5.25% at the end of 2023 (median projection).

Since then the US CPI-U inflation rate was reported as having fallen to 6.4% in January 2023, having averaged 8.0% in 2022. However, the core inflation rate (less food and energy) dropped to just 5.6% in January, having averaged 6.2% in 2022, pointing to broader-based price pressure amid a very tight labor market. Unemployment moves at a long-term low, employment has continued to register relatively robust increases, and wage growth is still strong, whilst job vacancies remain high.

Real GDP growth has continued to moderate, and could slow to about 1.4% this year and to 1.0% next year (IMF, January 2023), with the tightening cycle increasingly throttling economic activity, in particular domestic demand. While the restrictive monetary policy course is showing its effects on the interest-sensitive housing market, non-residential fixed investment as well as private consumption kept increasing in the final quarter of 2022. In 2022 as a whole, real GDP had increased by 2.1%, chiefly driven by consumer spending, exports and inventories, whereas residential investment posed a drag on GDP growth.

At this stage, we still expect the Fed funds rate to be lifted to 5.25-5.50% this year, while we do not forecast a first rate cut to occur until the first quarter of 2024 at the earliest.

Meanwhile, failure of the main parties to agree on lifting the statutory debt ceiling, i.e. the total amount of money the US government is authorized to borrow to meet its existing legal obligation, carries the risk of a market upset, if Congress does not act on time to raise or suspend the debt ceiling. The Republican Party commands a thin majority in the House of Representatives, leading to a political impasse in this case. However, we consider it more likely that some last-minute agreement will be struck.

2. Euro area

Economy holding up slightly better than feared over the winter season 2022/2023

Supported by extensive government measures, the euro area economy overall held up better than anticipated against the backdrop of rising energy costs. EU countries have allocated a total of about EUR 657bn euro (as of 13-Feb-23) to cushion adverse effects on consumers and businesses since September 2021, when energy prices started to post stronger increases amid eased corona restrictions, later dramatically accelerated by Russia's military attack on Ukraine.

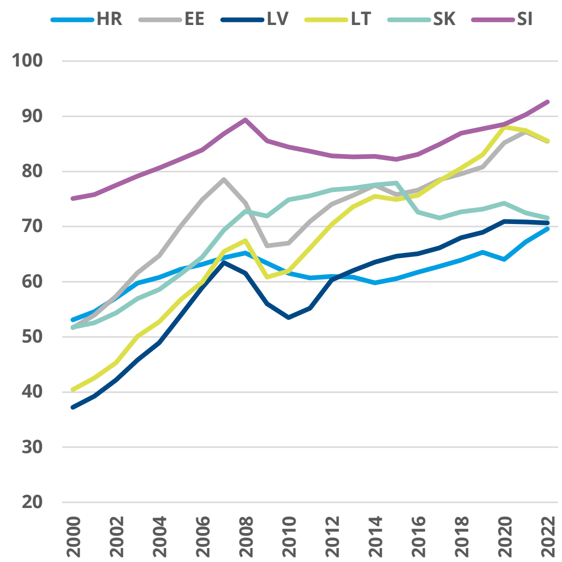
Real GDP in the euro area continued to grow over the course of 2022, although growth almost came to a halt in Q4-22, with the output only expanding by 0.1% against the preceding quarter. Thanks to a significantly more dynamic first half of the year, euro area real GDP ultimately increased by 3.5% in 2022. Countries with high dependency on tourism, which at the height of the pandemic had suffered steep declines in GDP, benefited from recovering travel activity last year.

EA20! – Croatia becoming the latest euro area member

Croatia, which in January 2023 became the 20th country to introduce the euro as its currency, counts among these economies. Following GDP growth of 13.1% in 2021, the Croatian economy increased by another 6.3% in 2022. On 10 February 2023, we have published the initial sovereign rating of 'BBB' for the Republic of Croatia, with a stable outlook. We assess medium-term prospects of the Croatian economy as supported by tourism, by the extensive EU funds and by the national structural reforms set out in Croatia's Recovery and Resilience Plan (RRP). Continued implementation of the RRP should unleash further Croatia's growth potential, potentially enabling an accelerated growth convergence towards EU levels, as this process has been rather gradual over recent years (see Figure 5). In our view, structural challenges relate to the business environment, unfavorable demographics, and slow productivity growth.

Figure 5: Croatia's income convergence towards EU levels has progressed rather gradually, but should accelerate in light of its EMU accession

GDP per capita in % of the weighted EU average



Sources: IMF, Creditreform Rating

Cautious economic outlook for 2023 despite slight upward revision of our GDP growth forecast

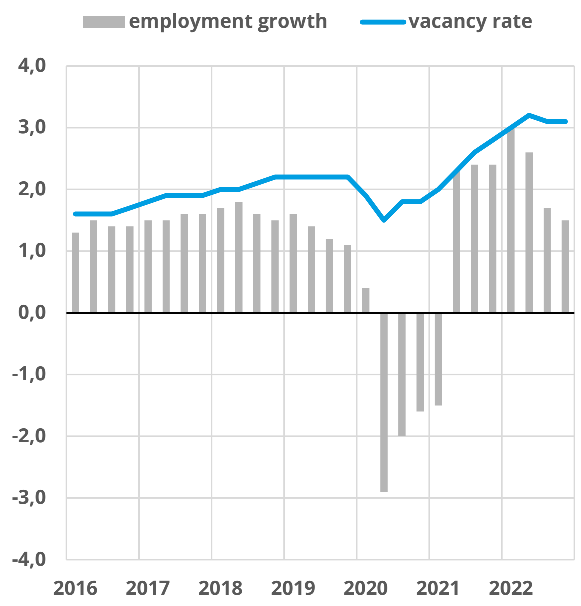
Among the four largest euro area economies, German and Italian real GDP declined in the final quarter of 2022 respectively, inching closer to a technical recession, i.e. two consecutive quarters with declining economic output. While we expect the euro area as whole to avoid such a scenario, we expect euro area real GDP growth to record a significant slowdown for the full year 2023, due to the weak economic winter season 2022/2023. Private consumption looks set to remain burdened by rising costs beyond energy, as rising core inflation rates suggest, although the abovementioned government support as well as a still comparatively positive labor market situation represent some counterweights.

Euro area unemployment has stabilized on a relatively low level, posting at 6.7% in January 2023, corresponding to the average rate in 2022. At the same time, the job vacancy rate remains at a comparatively high 3.1% as of Q4-22 (see Figure **6**). Labor shortages remain a pressing issue for European businesses, as once more illustrated by a recent surveys provided by the European Commission, referring to the first quarter of 2023. Although nominal wages look set to rise significantly, in real terms wage growth may still post another decline this year.

Whilst considerable EU funding linked to the implementation of the national RRPs continues to back investment, less favorable financing conditions on capital markets amid ongoing monetary policy tightening will likely constrain gross fixed capital formation in the near term. Supply shortages of materials and equipment have eased somewhat. That said, compared to the final quarter in 2022, the overall economic sentiment indicator for the euro area, which also includes consumer sentiment, has improved at the beginning of 2023, pointing to some acceleration of economic activity. Likewise, the Composite Purchasing Managers' Index (PMI) for the euro area continued to climb in February, in particular boosted by improving sentiment in the service sector.

Figure 6: Resilient euro area labor market should remain supportive for economic growth

Annual growth in total employment, job vacancy rate in industry, construction and services, both quarterly in %



Sources: Eurostat, Creditreform Rating

Prospects for exports have brightened to some extent, given China's rebounding economic performance amid relaxation of Covid-19 restrictions. Amid slowing domestic demand, net exports should contribute positively to GDP growth this year and next.

At this stage, we expect euro area GDP growth to decrease to about 0.8% in 2023, which represents an upward revision to our last Economic Briefs (Nov-22). Price pressure via the energy component should fade compared to 2022, whilst higher prices for a broader range of products and services may prove more persistent, also given signs of second-round effects.

ECB unlikely to cut rates before 2024

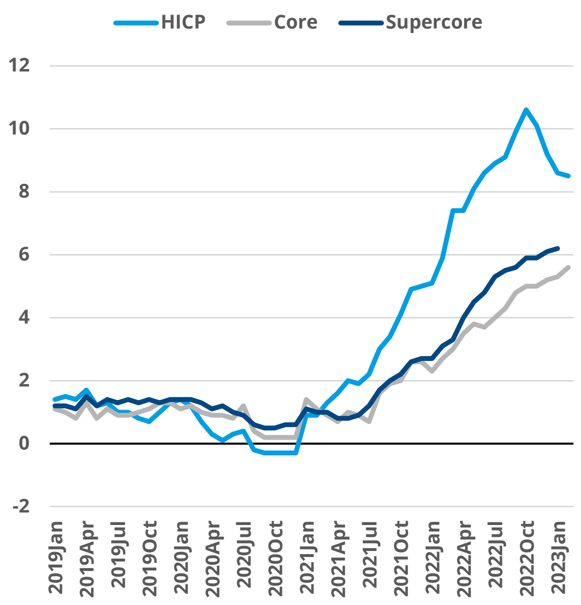
The ECB's more forceful response to high inflation rates than initially assumed is thus likely to show a greater dampening effect in 2024. We expect total economic output to expand by 1.4% next year, with moderate growth impulses from domestic demand

and net exports alike. While private consumption could gain some traction in view of strong wage growth and assumed moderating inflation rates, investment should remain supported by funding related to NextGenerationEU for the continued green and digital transformation.

The inflation rate stands at 8.5% in February 2023, following an average of 8.4% in 2022 (2021: 2.6%). Following its average level of 4.0% in 2022, the core rate (excluding energy and food), climbed to 5.6% this February, underscoring rising underlying pressure (see Figure 7). Central and Eastern European countries continue to post the highest readings with regard to both measures.

Figure 7: Measures of underlying inflation point to more persistent price pressures

Annual percentage changes; core inflation excl. energy and food, supercore inflation comprises cyclically sensitive HICP items from core inflation



Sources: ECB, Creditreform Rating

In the face of broadening price increases, the ECB has stayed the course on its more aggressive tightening, without much forward guidance, as decisions remain highly data-dependent. However, in what represents a rather unusual move, the rate increase by 50 basis points in March 2023 was literally indicated during the monetary policy meeting this February.

In its March 2023 macroeconomic projections, the ECB has revised down its HICP inflation projections, to 5.3% for 2023, 2.9% for 2024 and 2.1% for 2025, while it increased its forecast for core inflation (excluding energy and food) for 2023 to 4.6%. Core inflation for the two following years was revised down, and is now expected to average 2.2% in 2025.

At the same time, the ECB increased its GDP growth forecast for the euro area for 2023, to 1.0%, while slightly lowering expectations for the GDP expansion in the following two years, to 1.6% each.

Referencing the latest market tensions over the resolution of two US banks and central bank support of a large Swiss financial institution, the ECB also reassured market participants that it stood ready to respond as deemed necessary, while stressing the resilience of the euro area banking sector.

From their current level of 3.75%, 3.50% and 3.00% (marginal lending facility, main refinancing rate, deposit rate), we still expect the ECB to raise its policy rates by an additional 50bp, presumably in two 25bp steps, by the end of the current year. However, uncertainty around these expectations has arguably become more pronounced in view of the most recent market tensions. The data-dependent approach remains key.

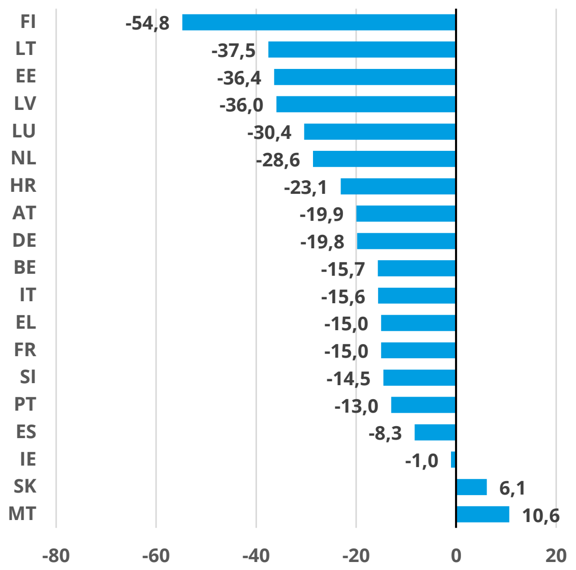
For the time being, the ECB's Governing Council intends to continue reinvesting the principal payments from maturing securities purchased under the Pandemic Emergency Purchase Program (PEPP) until at least the end of 2024, whereas the Asset Purchase Program portfolio will be wound down gradually from March 2023, with an initial monthly portfolio reduction of EUR 15bn until June 2023. The subsequent pace of the reduction will be determined over time.

Risks to our euro area forecast are still tilted to the downside

A possibly more persistent high-inflation environment could keep the ECB on its current tightening path for longer, with a related risk of eventually causing a more pronounced downturn. Apart from that, a possible further escalation of the tensions with Russia could lead to a markedly deteriorated outlook, and possibly meeting with consumers who have come close to their limits in terms of reducing their gas consumption (see Figure **8**).

Figure 8: Natural gas consumption in Europe is declining sharply

Change in natural gas consumption, July-December 2022 vs. average of 2017-21



Sources: Eurostat, Creditreform Rating

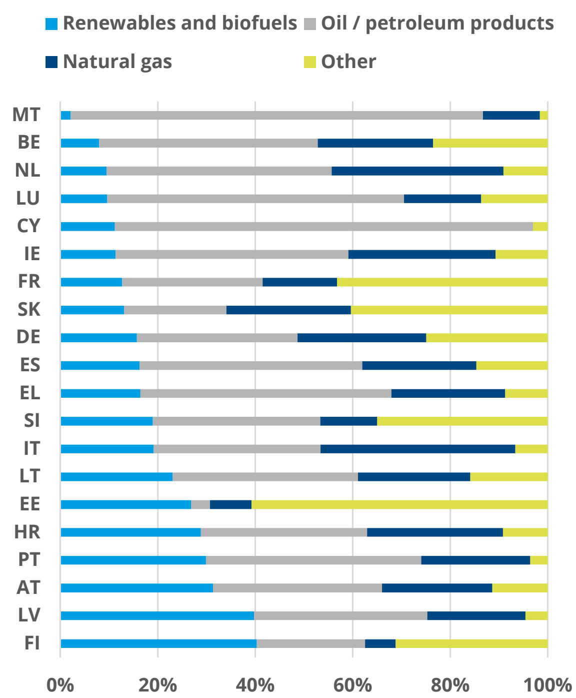
On the other hand, a more positive scenario could emerge if the economic cycle proves more robust than currently assumed. Such a scenario could feature faster progress in terms of adapting to changes on energy markets and in shifting towards renewables as considerable investment is poured into the green transition. In this context, illustrating efforts to find alternatives to heating systems based on oil and gas, it may be worth citing that the production of heat pumps in Germany increased by 48.9% over the first three quarters of 2022 compared to the same period a year earlier.

Nevertheless, there remains a long way to go to establish new and reliable energy sources and related infrastructure. As of 2021, the overall share of energy from renewable sources in percent of gross final energy consumption, reached more than a fifth (21.8%), up by 3.8 percentage points compared to 2016, with a relatively large variety among the EU members (see Figure **9**).

Some of the goals set amid the transition may be hard to achieve, for various reasons. The current debate over the ban on new combustion engine cars from 2035 by the EU may serve as a recent case in point. Apart from Germany, Italy and Poland are among the members having signaled opposition to the plan in its current form, with e.g. Germany pushing for exemptions for combustion engine cars that use climate neutral e-fuels. The transitioning process may after all be slowed by possibly required fiscal consolidation and/or reprioritization in some cases.

Figure 9: Many euro area members facing significant catching-up potential regarding renewables

Share in gross available energy in %, 2021



Sources: Eurostat, Creditreform Rating

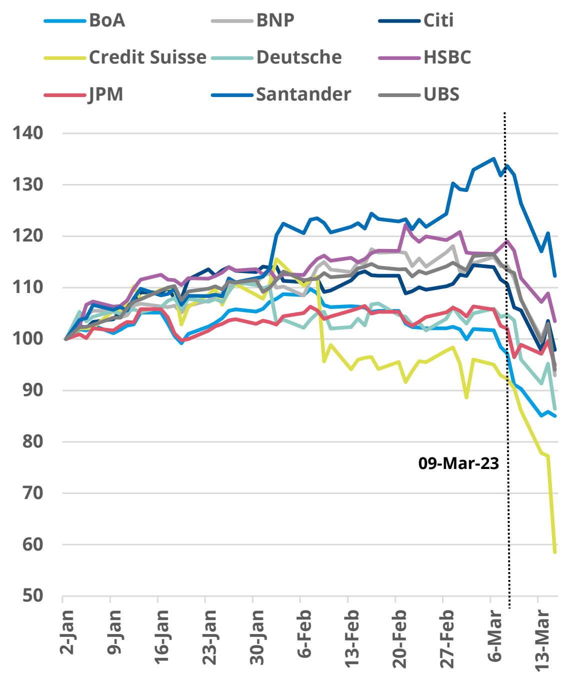
Regarding the digital transition and the aim to boost domestic production of semiconductors, partly addressed by the EU Chips Act, planning and administrative processes are to be accelerated. Moreover, the EU may be set to join the battle of subsidies on the global stage to ensure competitiveness of this industry, as other jurisdictions harbor similar ambitions.

Balance sheets and debt-servicing abilities to be monitor more closely

Against the backdrop of higher funding costs, we continue to monitor debt-servicing abilities of the private sector, as well as concomitant asset quality and developments in the banking sector more generally. While the European banking industry seems to have emerged from the pandemic in a solid shape and remained resilient as loan moratoria expired, there are pockets of vulnerability, partly depending on credit exposure to more vulnerable industries and/or households, given still fragile economic circumstances.

Figure 10: No one's spared by financial turbulences

Share prices of major financial institutions, 02-Jan-23=100



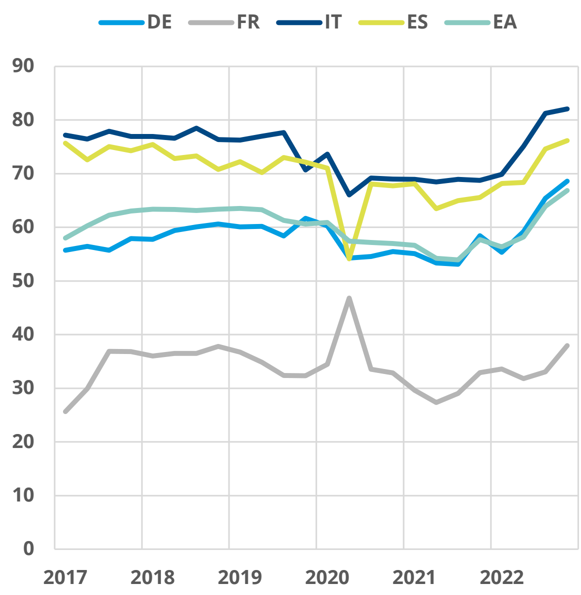
Sources: Refinitiv, Creditreform Rating

Moreover, as the occurrence regarding the Silicon Valley Bank in the US suggests, more cases of insufficient asset/liability management may emerge, and financial institutions already perceived as having performed weakly more recently face a hard time (see Figure **10**),

Despite cost pressure and interest on mortgages having remained high or rising, house price dynamics have barely softened, although more recent data may point to a greater impact taking hold. Banking sectors with large mortgage portfolios and higher exposure to variable-rate mortgages will certainly have to be monitored more closely (see Figure **11**). Macroprudential policies are being adjusted in a number of European economies, illustrating that supervisors keep an eye on potentially deteriorating developments.

Figure 11: Significant pick-up in variable interest rate loans amidst aggressive monetary policy tightening

Share of new loans with a floating rate or an initial rate fixation period of up to 1y in total new loans from MFIs to households and NFCs, in %



Sources: ECB, Creditreform Rating

What is more, heightened attention will have to be paid to developments in commercial real estate (CRE), which still has to adjust to more flexible working patterns following the pandemic, in addition to mounting financing costs and higher energy prices. A recent assessment of the European Systemic Risk Board (Jan-23) has highlighted the potential systemic impact of adverse developments in CRE on the financial system and the real economy against the backdrop of rising construction and funding costs amid declining prices in the market segment since the second half of 2021. The sector's importance for the economy is considerable in the Netherlands, Germany, Luxembourg, Finland and France, judging by CRE investment transaction volumes.

3. Germany

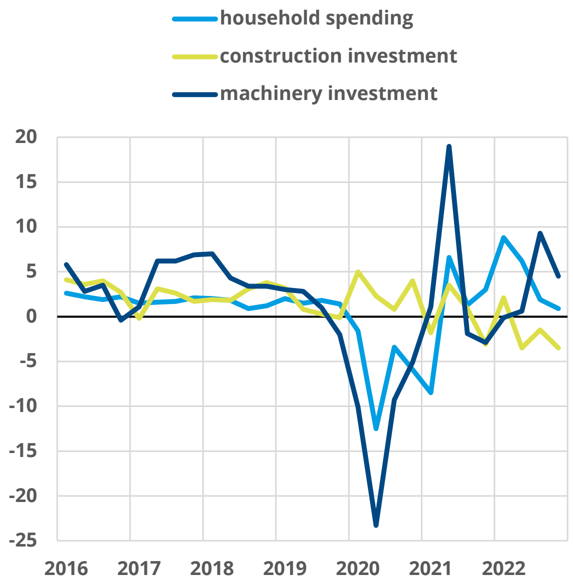
GDP decline in Q4-22, but technical recession may still be avoided

Germany's real GDP grew by 1.8% in 2022, following an expansion of 2.6% in the preceding year. Private consumption constituted the main driver for economic growth last year, partly boosted by further easing of corona restrictions, and supported by government measures to soften the blow from soaring energy costs. Government consumption and gross fixed capital formation added positively to GDP growth as well, although to a markedly smaller extent compared to household expenditure. With imports posting a considerably stronger increase than exports, net exports contributed negatively. While parts of the service sector benefited from catching-up effects following the corona crisis, in particular the construction sector was heavily affected by shortages of materials and higher costs, in combination with rising financing costs. As a result, the construction sector posed a drag on GDP growth, as did the manufacturing sector.

In the final quarter of 2022, the German economic output fell by a downward revised 0.4% against the preceding quarter, dragged down by the burden placed on the economy by high energy prices and ongoing, albeit somewhat less pronounced, global supply bottlenecks. Private consumption fell by 1.0% q-o-q, not least as relief in the form of a low-cost ticket for public transport and a rebate on fuel expired. Even though nominal wages posted the strongest increase since 2008 last year, rising by 3.5% in 2022, surging HICP inflation, averaging 8.7%, left real wages to decrease for a third consecutive year, cutting into private households' disposable income (see Figure **12**).

Figure 12: German households feeling the pinch

Annual percentage changes, chain-linked



Sources: Eurostat, Creditreform Rating

Construction investment posted a third consecutive decline in Q4-22, additionally burdened by cold weather in December and a still high share of cancelled projects amid the abovementioned adverse factors. Investment in machinery in equipment dropped in Q4-22 as well, as did overall exports. Energy-intensive industries such as manufacturing of chemicals and manufacture of basic metals saw their gross value added fall markedly in last year's final quarter.

More positive signals for the first quarter of 2023, broadening strike action could impair visibility

More recently, the weekly activity index provided by Bundesbank, points to an implied GDP growth rate of 0.6% for the last 13 weeks up to 06 March compared with the preceding 13 weeks, suggesting that the German economy may avoid a technical recession after all. Some activity data available for January, such as the volume of retail sales and turnover in the manufacturing sector (including construction), seem to point to a weaker outcome, though, whereas new manufacturing orders and industrial production had a good start into 2023, posting increases vis-à-vis December 2022.

Important sentiment indicators such as the ifo business climate also back the impression that the German economy may have turned the corner, with the overall business climate having posted a fourth consecutive increase in February 2023, on the back of improving expectations with regard to the respective following six months. Nevertheless, looking at the breakdown of the business climate by sector, business sentiment in construction as well as in the trade sector remains rather dampened. Meanwhile, a decline in February's PMI for the manufacturing sector masks improving supplier delivery times and a fall in stocks of purchases, while the service PMI increased a second time in a row, moving slightly above the 50-point threshold hinting at increasing business activity in the sector, underscoring more constructive prospects for the further course of 2023.

Looking ahead, private consumption will likely remain affected by high prices for a broader range of products, while energy prices may continue their retreat seen over the last few months. The labor market situation should by and large remain supportive to household expenditure, alongside recent increases to the minimum wage and government measures to limit negative effects on private households from high energy prices. Caps on electricity prices as well as on gas and heating prices have been in force since January and March 2023, respectively. The most recent package of up to EUR 200bn follows on the heels of three support packages launched in 2022 and totaling roughly EUR 100bn to shield private households and firms from negative effects of the energy price shocks.

Labor market remains a supportive pillar for private consumption

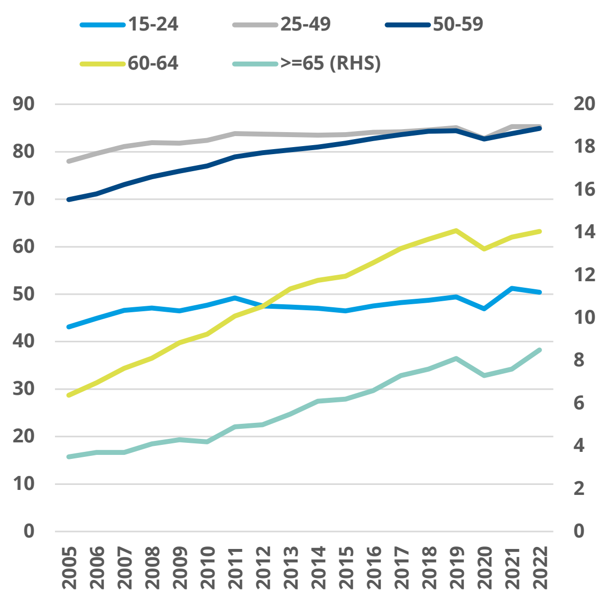
Higher wage demand is virtually omnipresent at the current stage, accompanied by broadening strike action and fueled by high inflation rates and broad-based shortages of staff in various industries. The majority of the 2023 negotiation rounds, affecting close to 11 million wage earners altogether, mainly concerns the service sector. However, at least with regard to 2023, real wages may well turn out negative again.

Meanwhile, the unemployment rate has stabilized near historic lows, standing at 3.0% in January 2023 (LFS-adjusted), while total employment has continued to increase, climbing by 1.3% y-o-y in 2022 as a whole. That said, hiring intentions in energy-intensive industries such as the chemical industry have been more muted lately, as the ifo employment barometer (Feb-23) suggests, although shortages of skilled labor remains a driving factor. In the machinery and electrical industry, hiring intentions remain pronounced. Overall, we expect unemployment to edge up somewhat in 2023, and employment to by and large stall on current high levels.

Taking a more structural point of view, Germany's labor participation rate remains high by European comparison, resuming its rise following pandemic-related distortions and reaching 79.6% as of Q3-22. Analysis of developments in different age cohorts suggests that participation among the age groups from 60 years and over has gone up significantly over the last two decades, presumably reflecting the increasing statutory retirement age as well as related political decisions, and generally more inclusive labor market policies (see **Figure 13**).

Figure 13: After the pandemic-related dent, participation rates moving further upwards

Labor force participation rate by age cohorts in %



Sources: Eurostat, Creditreform Rating

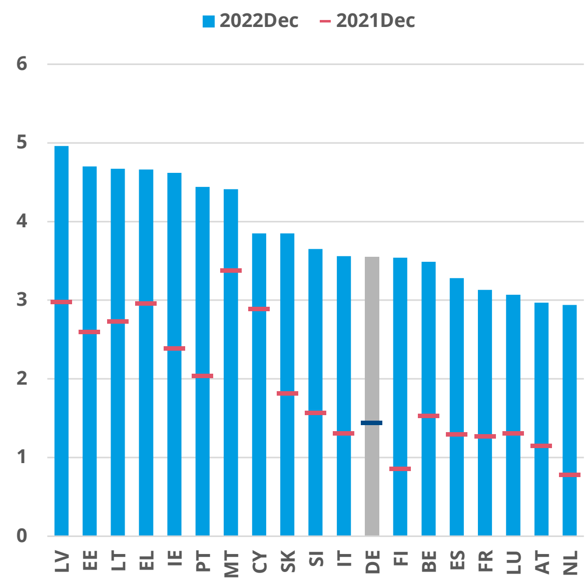
Amid attempts to increase transparency and create a basis for targeted policy recommendations, the newly created indicator of the 'labor market gender gap' by Destatis is to serve as a measure of inequality between men and women, taking into account differences in gross hourly earnings, hours worked and labor market participation. As part of the concept, the unadjusted gender pay gap was estimated to be at 18% in 2022, which after adjusting for equal qualifications, comparable job description and work background reduces to about 7%.

Challenges for investments, brightening prospects for exports

Despite headwinds from rapidly rising financing costs coming on the back of the ECB's more aggressive tightening cycle (see Figure **14**), investment could gain some traction in the near term, as some easing of supply bottlenecks could enable a reduction of the stock of unfilled orders, which remains on a high level. Recently retreating energy prices and the government's energy price brake should also bring some relief. Moreover, continued public investment in strengthening the green and digital infrastructure should exert some positive effects on private investment, although supply shortages in particular regarding ICT equipment were still quite pronounced as of January 2023. As regards the construction sector, we expect the described challenges largely to persist in the current year.

Figure 14: Unabated rapid growth in financing costs likely to dampen fixed investment

Composite cost of borrowing indicator for NFCs in %, new business



Sources: ECB, Creditreform Rating

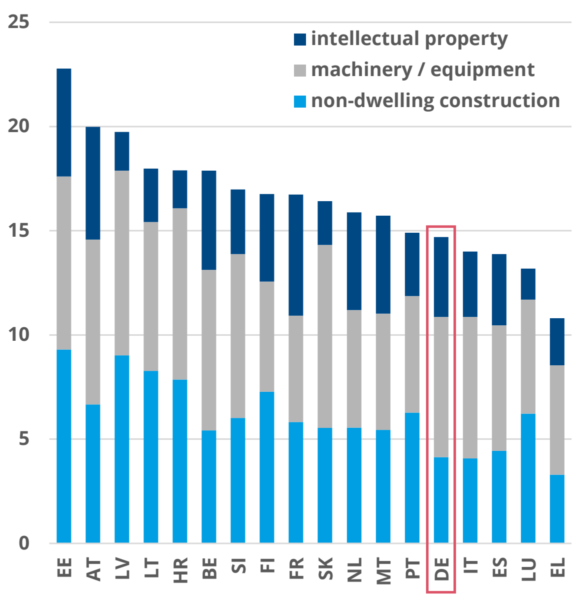
Given the expected acceleration of Chinese economic growth, alongside the assumed moderate expansion of the European and US economy, prospects for German export growth have brightened somewhat. Reflecting this, the ifo export expectations are back in positive territory, suggesting that a higher percentage of companies is becoming more optimistic by now, although the net share of optimists remains rather moderate at this stage.

Overall, we expect real GDP growth to decrease markedly to 0.2% this year, on the back of a weak start into 2023. For 2024 we assume a slight growth acceleration to 1.4% in 2024.

Uncertainty around the forecasts remains at a high level in view of the ongoing war in Ukraine and the related geopolitical tensions. Similar to the pandemic phase, there are enormous costs involved in alleviating adverse effects on the economy from the energy price shock, while dealing with such shocks also requires a massive amount of human resources, carrying the risk that implementation of other political priorities suffers and/or experiences funding cuts. In addition, increasing signs of second-round effects from high consumer prices may mean a prolonged phase of inflation rates above the ECB's target. Adding to these risks for the medium-term growth outlook, Germany displays catching-up potential in potential growth-enhancing fixed investment (see Figure **15**).

Figure 15: Germany's non-residential investment appears relatively low from a European perspective

Average 2017-21, in % GDP



Sources: Eurostat, Creditreform Rating

Business insolvencies rise moderately

Business insolvencies continue to move on a lower level than prior to the outbreak of the corona crisis. Insolvencies rose by 4.3% to 14,590 cases in 2021-22, but remained roughly 22% below the respective reading in 2019. At the same time, the request for insolvency increased by 10.8% m-o-m in Feb-23, after having declined by 3.2% a month earlier.

We expect the number of bankruptcies to continue to rise over the coming months, whilst government support to limit energy costs should again prevent any dramatic developments. However, rising debt-servicing cost and higher cost of new loans are likely to take their toll on some businesses.

Risks in the financial sector more accentuated in the current environment

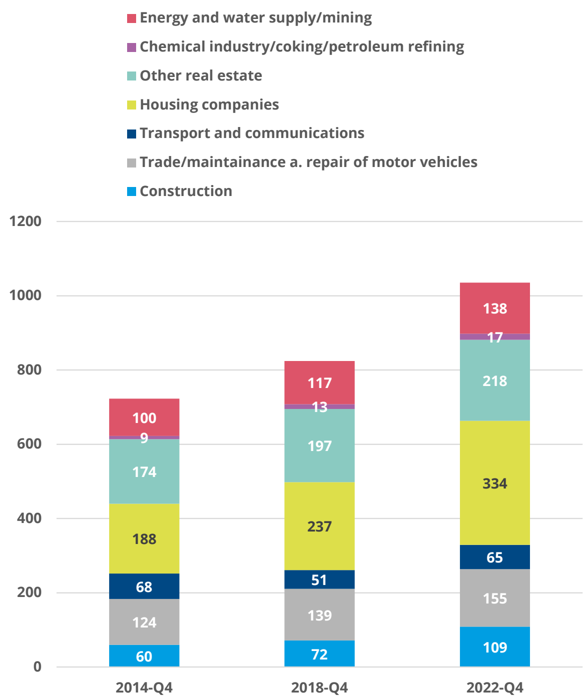
Against this backdrop, exposures of the financial sector will have to be monitored more closely, notwithstanding a relatively solid shape of the German banking sector (see Figure **16**).

Drawing on the latest Financial Stability Report issued by the Federal Financial Supervisory Authority (BaFin), about a third (34%) of German financial institutions supervised by BaFin were subject to heightened interest rate risk, implying a drop of the equity ratio by more than 20% in case of a change in interest rates by 200 basis points. Although profitability of the banking sector should benefit from a higher interest rate environment, a possible inversion of the yield curve could hamper profitability after all.

The German housing market remains in the limelight, given rapidly rising house prices and increasing lending for residential real estate. Due to the mix of increasing costs of new financing, partly rising costs of servicing existing private sector debt, as well as high energy and material costs, risks on the real estate market have gone up, entailing potential negative repercussions for the banking sector. According to the Bundesbank, the outstanding volume of residential credit amounted to about EUR 1,774bn as of Q4-22, corresponding to an increase of 62% compared to Q4-09, when the ongoing upward trend was about to start.

Figure 16: Geopolitical developments and monetary tightening harbor credit risks to the energy, construction and housing sectors

Exposure of German MFIs to selected industries, as measured by loans to domestic enterprises and self-employed persons in bn euros



Sources: Bundesbank, Creditreform Rating

Affordability indicators such as the OECD's price-to-income ratio have backed the assessment of prevailing overvaluations. As a consequence, macroprudential levers such as a higher countercyclical capital buffer and a newly introduced systemic risk buffer regarding residential real estate loans were activated with effect from February 2023 to counter increasing risks regarding the property sector. Moreover, according to the January 2023 Bank Lending Survey, German banks tightened their credit standards for loans to enterprises, loans to households for house purchase as well as consumer credit in Q4-22.

Various metrics measuring German housing prices still point to strong annual price increases, although the indicators also hint that prices have started to recede of late. Growth in lending to private households for house purchases has been slowing since last year. House price increases should thus continue to moderate this year, although supply-demand fundamentals could put a floor to that at some point.

4. United Kingdom

The UK economy's post-pandemic recovery virtually came to a halt

Following an expansion of 0.5% in Q1-22 (q-o-q), the UK's total output by and large stagnated in the following three quarters, with economic activity in the third quarter negatively affected by an exceptional bank holiday for the state funeral of Queen Elizabeth II in Sep-22. Drawing on preliminary ONS data, real GDP growth slowed to 4.0% last year (2021: 7.6%), on the back of decreasing growth in private and government consumption as well as a slowing pace of investment expansion. This notwithstanding, imports expanded strongly, leaving net exports to exert a drag on GDP growth.

In view of the constraints on both the domestic economy and the external environment, we expect UK real GDP to decrease slightly in 2023, by -0.4%. Even though we assume energy prices will moderate further over the course of the year, likewise entailing improving prospects for trade partners, adverse effects from tighter monetary policy on economic activity should further unfold, likely restricting growth dynamics in 2024. At this stage, we expect total output to increase moderately by 0.9% next year.

Sentiment indicators such as the monthly PMIs have hinted at very subdued economic activity around the turn of the year, with the services, construction and manufacturing PMIs all in slightly contractionary territory in Dec-22 and Jan-23. That said, the service PMI recovered into expansionary territory in February. Consumer confidence as captured by the GfK indicator fell in Jan-23, posting close to its record low reached in Sep-22, but recovered somewhat in February, overall still boding ill for the near-term outlook on private consumption.

Strong government support could still enable gentle growth of household expenditure in 2023

To alleviate the burden placed on consumers and businesses due to high energy prices since last March, successive support packages were announced by the government, including the May-2022 cost-of-living package, the Sep-2022 energy package, as well as measures announced with the growth plan after the Oct-2022 reversal and the Nov-2022 Autumn Statement. Overall, the packages are estimated to come to a combined GBP 58.4bn in the current fiscal year 2022/2023 (FY 22/23). First indications for the following fiscal year point to about GBP 28bn (OBR intelligence). The more recent Spring Budget (15 March 2023) extends energy bill support for private households for another three months until the end of June 2023, and ramps up childcare benefits.

That said, the cost of living remains high and the freeze in personal tax allowance thresholds announced some time ago is going ahead, eating into disposable income. While consumer price inflation (CPI) eased slightly in Jan-23, it remained in double digits, posting at 10.1%, having averaged 9.1% over 2022. While wholesale gas and oil prices have fallen over the last few months, and energy prices should moderate further over the course of the year, the CPIH for all services has trended upward (Jan-23: 5.2%), suggesting broadening price pressure. Despite increasing wage growth, including a 9.2% increase in the national living wage from April 2023, real wages are thus likely to remain negative in 2023.

Meanwhile, the unemployment rate has remained near long-term lows, posting at 3.7% in the three months to Nov-22 (persons aged 16 to 64, ONS), comparing low in a European context. Employment has still trended upward over the year to Q3-22, moving roughly at the high pre-pandemic level. Decelerating economic activity should put the labor market under pressure, but unemployment is likely to rise only modestly in the near term, as we assume businesses to decrease vacancies and hoard labor.

Prospects for fixed investment have clouded

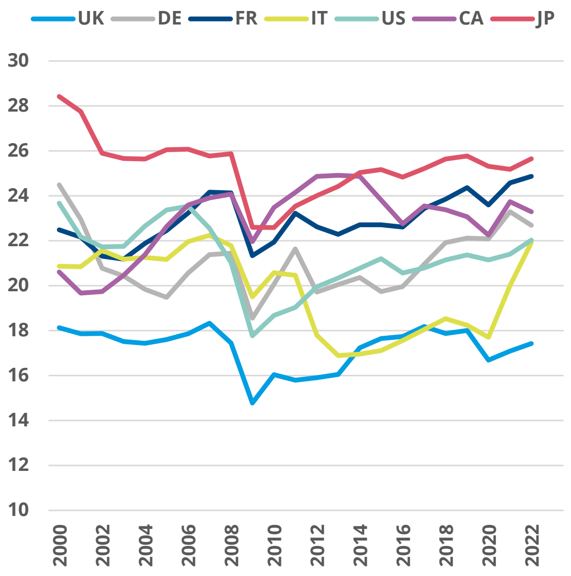
The imminent expiry of investment incentives (super-deduction) and an increase in the corporation tax rate from 19% to 25% from this April add to existing cost pressure and struggles to find skilled labor, prospectively weighing on the UK's investment activity. Moreover, while shortages of materials have eased somewhat lately, higher market interest rates have pushed up rates for new mortgages and business loans.

According to the most recent Decision Maker Panel data published in Feb-23, average expected annual investment growth could be negative over the next year, extending the trend of already lackluster capital spending since 2016 (see Figure **17**), potentially with negative consequences for productivity and, ultimately, potential growth. We will also monitor any potential changes to insolvency dynamics as government support is partly withdrawn from this April. From Feb-22 to Jan-23, the cumulative number of insolvencies was by almost a third higher than in the respective period in 2019 (+31.1%, Insolvency Service). More positive aspects include envisaged relief for businesses e.g. in the form of a GBP 13.6bn package over the next five years for business rate payers. In addition, a new policy announced with the Spring Budget introduces tax allowances for business investment for a period of three years starting from this April.

Acknowledging recent statistical changes around trade data collection and coverage, we note that analysis by the Bank of England (BoE, Feb-23) following adjustments to these issues points to a weaker profile of trade in goods than initially exhibited vis-à-vis the EU over the last two years following the Brexit-related regime change. Drawing on IMF data on global goods exports, the UK's share in the global market has shrunk to 2.1% in 2021 (2016: 2.6%), a longer-term low, although pandemic-related distortions may have had a bearing here, too. Trade in services with the EU appears negatively impacted by the post-Brexit trade regime to some extent as well.

Figure 17: Anemic investment activity should weigh on the UK's underlying growth

Total investment as % of GDP



Sources: IMF, Creditreform Rating

Looking ahead, alongside persisting Brexit-related effects, export performance is likely to continue to feel the consequences of weakened global economic activity following Russia's military attack on Ukraine. Amid muted and only gradually accelerating domestic demand, real imports will presumably post negative growth this year and next, ultimately leading to a positive contribution from net trade.

Weaker economic growth prospects posing challenges to envisaged fiscal consolidation over the medium term

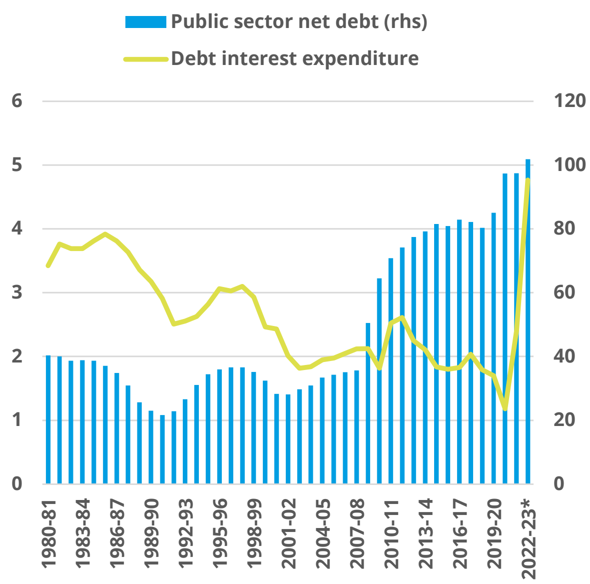
In the face of soaring energy and food prices, the government's efforts to alleviate adverse effects on private households and businesses will likely result in another pronounced deficit in fiscal year (FY) 22/23. While a growth plan announced during the brief term of the previous prime minister in September 2022, including a number of tax cuts, was almost fully reversed by the current leadership, net borrowing will rise significantly in the short term. That said, the current government also presented envisaged measures to restrain spending and increase taxes over the medium term in a bid to rein in public finances.

Public sector net borrowing in the first ten months of FY 22/23 came to GBP 116.9bn, corresponding to an increase of 6.3% on the same period of the preceding fiscal year, while remaining 15.8% below OBR's November forecast profile. On the revenue side, in particular income tax receipts, VAT revenue and national insurance contributions showed a more favorable outcome. With regard to the expenditure side, a lower level of subsidies and grants, as well as lower

Debt affordability has deteriorated since our last review. On the back of increased borrowing and higher borrowing costs on the capital markets, and amid a more aggressive monetary policy tightening cycle than previously anticipated, debt interest spending could be on course for the highest share versus GDP and total revenue since the late 1940s (see Figure 18).

Figure 18: Interest expenditure ballooning to multi-decade high

Debt interest spending and public sector net debt as % of GDP, *) Nov-22 OBR forecast for fiscal year 2022-23



Sources: OBR, Creditreform Rating

However, interest payments have come in slightly more favorable than envisaged in the OBR November 2022 forecast in the first ten months of the fiscal year ending in March 2023, amounting to GBP 95.6bn. For the full FY 22/23, the government had expected debt interest payment to reach GBP 120.4bn in its Autumn Statement. Nevertheless, at 9.4% of total revenue (Maastricht terms), measured as four-quarter average as of Q3-22, interest-to-revenue was higher than in any of the EU member states, and is likely to decline only gradually over the next few years.

Interest rate hiking cycle to approach its peak

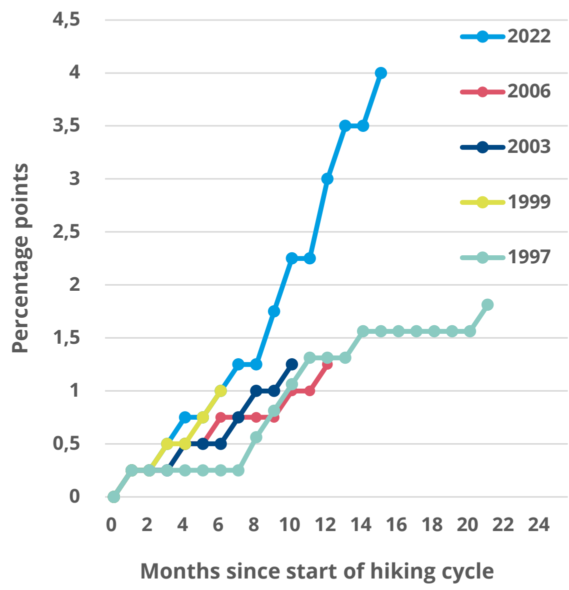
The impact of an increase in short-term interest rates by one percentage point would lift debt interest spending by about GBP 7.9bn in FY 26/27 (OBR estimate), suggesting that fiscal pressure via cost of debt could remain elevated over the medium term, also as a higher debt stock affects sensitivity to increases in long-term rates.

With a view to domestic monetary policy, we expect a last hike of the Bank Rate by 25bp to 4.25% to occur in March 2023. Moreover, we expect the policy of unwinding the accumulated asset purchases under the Asset Purchase Facility to continue. The sale of the portfolio of long-dated UK government bonds purchased by the MPC between 28 September and 14 October 2022 (GBP 19.3bn) during an episode of asset price turbulence, partly in reaction to the mini-budget of the previous finance minister in September 2022, has been fully sold as of January 2023.

At its meeting ending on 1 February 2023, the MPC raised its policy rate by 50bp to 4.0%, with two of the nine-member committee preferring to maintain the rate at 3.5% (see Figure **19**). While headline CPI inflation was judged as likely to experience a sharp decline over the rest of the year, mostly due to energy and goods prices, the committee perceives in particular underlying inflationary risks ultimately as skewed towards greater persistence. Against this backdrop, we would view a first rate cut in 2023 as a rather remote possibility at this stage.

Figure 19: Bank of England aggressively tightening monetary policy

Key policy rate increases during historical tightening cycles in p.p.



Sources: Bank of England, Creditreform Rating

In the year to December 2022, house prices still exhibited an increase by 9.8% y-o-y (Dec-21: 8.1% y-o-y), drawing on the HM Land Registry's UK house price index for all types of property. However, we would expect house price growth to calm somewhat, reflecting weakening economic activity and tighter monetary policy. Various metrics and surveys linked to the housing market, including property transactions statistics, RICS UK Residential Market Survey and mortgage approvals for house purchases point to some softening of the housing market lately, which may eventually start to show in house price dynamics as well. OECD data on housing affordability, such as the price-to-income ratio, continue to hint at stretched valuations, exceeding highs last seen prior to the global financial crisis.

Issues over Northern Ireland protocol may be brought to an end by the 'Windsor framework'

While the Northern Ireland Protocol is an important part of the UK's withdrawal agreement, it has been a persistent source of political and societal challenges since entering into force two years ago. Following lengthy negotiations, a political agreement in principle between the UK and the European Commission has been reached in late February. The so-called 'Windsor Framework' could thus finally put an end to the dispute over the Northern Ireland Protocol.

The Windsor Framework has been carried out within the framework of the UK's withdrawal agreement, and delivers a form of dual regulation, intended to work for businesses and consumers in Northern Ireland. The new arrangement aims at facilitating a smooth flow of trade in goods within the UK internal market, in particular regarding agri-food. Also, the frequency rate of identity checks of retail goods will be gradually reduced over the next years.

While Northern Ireland is to benefit from VAT-changes and excise duty relief under UK rules, several safeguards have been agreed to ensure the integrity of the EU Single Market. Moreover, the Windsor Framework provides for solutions to several practical issues that have been raised by businesses and citizens from Northern Ireland, e.g. related to banned products and pet travel.

In how far the European Court of Justice should have jurisdiction to rule on matters of EU law in Northern Ireland had been heavily debated. While, generally, the ECJ will remain the sole and ultimate arbiter of EU law under the Windsor Framework, the so-called 'Stormont brake' foresees an institutional mechanism to enable the UK's government to veto the application of amended or replacing provisions of EU law, provided that 30 members of the Northern Ireland assembly, from at least two parties, ask the UK to stop a potential new EU rule from applying in Northern Ireland.

The necessary measures to translate the solutions under the agreement into legally binding commitments is envisaged to take place in the near term. However, we expect the political process to take some time, as a fast response of Northern Ireland's DUP appears rather unlikely, with polls among Norther Ireland's citizens hinting at a lengthy process.

Figure 20: Our forecasts have been revised upwards for 2023

In %, IMF forecasts for World, China, US

	2010-19	2020	2021	2022	2023e	2024e
World	3,7	-3,0	6,0	3,4	2,9	3,1
Euro area	1,4	-6,1	5,3	3,5	0,8	1,4
Germany	2,0	-3,7	2,6	1,8	0,2	1,4
France	1,4	-7,8	6,8	2,6	0,6	1,5
Italy	0,3	-9,0	7,0	3,8	0,3	1,2
Spain	1,1	-11,3	5,5	5,5	1,6	2,1
UK	2,0	-11,0	7,6	1,4	-0,4	0,9
US	2,3	-3,4	5,7	2,0	1,4	1,0
China	7,7	2,2	8,1	3,0	5,2	4,5

Sources: Creditreform Rating, IMF

Related Credit Ratings

Rating Action 10 February 2023: Creditreform Rating has published the Republic of Croatia's initial rating of 'BBB', outlook stable
Rating Action 03 March 2023: United Kingdom's outlook revised to negative, credit rating affirmed at 'AA'

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