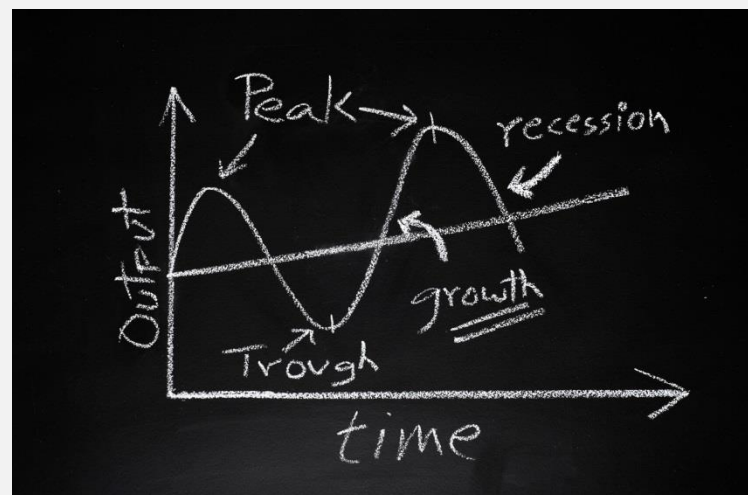


Creditreform Rating

CREDITREFORM ECONOMIC BRIEFS

Low growth, high inflation

August 2023



CONTENTS

1. World	4
2. Euro area.....	6
3. Germany.....	11
4. United Kingdom	15

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KEY TAKE-AWAYS

- 1.** We expect the **euro area's real GDP to rise by 0.9% in 2023**, a slight upward revision compared with our previous Economic Briefs, on the back of a better-than-expected first half 2023, although with rather heterogeneous developments across the four major euro area economies. With few signs of faster growth in the near term, we now forecast an **expansion of 1.1% in 2024**, lower than previously expected. Some recovery in private consumption should lend support, while public investment should remain backed by the advancing implementation of the EU-funded Recovery and Resilience Plans.
- 2.** While headline inflation rates continue to decrease, core inflation rates may prove somewhat stickier. We expect **the ECB to raise rates one more time this year** before pausing, and assume that the ECB's main refinancing rate should amount to **4.5% at end-2023 and 4.0% at the end of 2024**. A first rate cut in our view is unlikely to occur before the second half of 2024.
- 3.** Amid persisting cost pressure and further increases in mortgage interest rates, **house price dynamics** have softened considerably, and will likely continue to do so. The **European banking sectors** appear to be **relatively resilient**, and some **macroprudential levers have been activated** to mitigate risks to financial stability. Nevertheless, banking sectors with large mortgage portfolios and/or higher exposure to variable-rate mortgages will continue to require close monitoring.
- 4.** **Germany's economy has fared worse** than that of the other large euro area members lately, partly dragged down by pronounced weakness in the manufacturing sector. Construction remains burdened by still high costs, some persisting capacity constraints concerning material and labor, and by the sharply deteriorated financing conditions. Together with rather subdued key sentiment indicators, this has led us to **revise down our GDP forecast for 2023 and 2024**. For the whole year 2023, we now expect German real GDP to **decline by 0.1%, followed by an increase by 1.0%** in 2024, remaining below our GDP forecasts for the euro area. The labor market has proved fairly resilient so far, while the number of defaults has risen more significantly recently.
- 5.** Given a less negative development of the UK economy than previously expected, **UK real GDP growth should turn out positive in 2023 after all**. However, we now expect the **Bank of England to increase its policy rate further to 5.75%** later this year, in particular given stickier service inflation, which may heighten risks for the economy experiencing a sharper downturn and pockets of financial distress. We forecast **GDP growth rates of 0.5% for 2023 and 0.8% for 2024** at this stage. As regards the still tight labor market, structural changes to the composition of the workforce resulting from Brexit and geopolitics becomes clearly visible by now. With political noise having largely subsided after a turbulent phase last year, a memorandum of understanding with the EU on financial services cooperation was signed in June.
- 6.** In light of retreating headline inflation, **US economic growth continuing at a moderate pace**, and clearer signs of a cooling labor market, the **Federal Reserve has entered a fine-tuning phase** of its monetary policy cycle. We now expect the Fed funds rate to be lifted one more time this year, to 5.50-5.75%, and we continue to think that a first rate cut will occur in Q1-24 at the earliest.

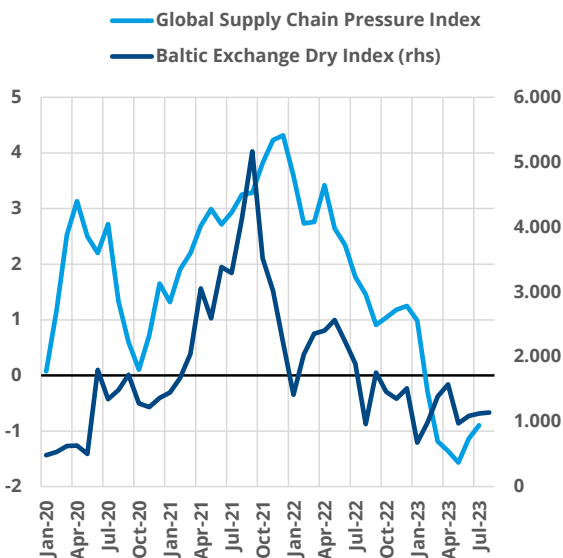
1. World

Economies continue to adapt to the negative reverberations from recent back-to-back crises

While global supply chain disruptions have largely abated (see Figure 1), other factors that have curbed global economic growth last year remain in place, with prospects for a renewed Black Sea grain deal shaky and potentially causing further disruption. Inflationary pressures are proving to be quite persistent, keeping central banks on their toes. The peak of monetary policy tightening thus seems to have been pushed back somewhat, directing the focus on the ability to manage a soft landing.

Figure 1: Supply chain frictions have eased

Global Supply Chain Pressure Index in standard deviations from average value, Baltic Exchange Dry Index (shipping freight-cost index) in points

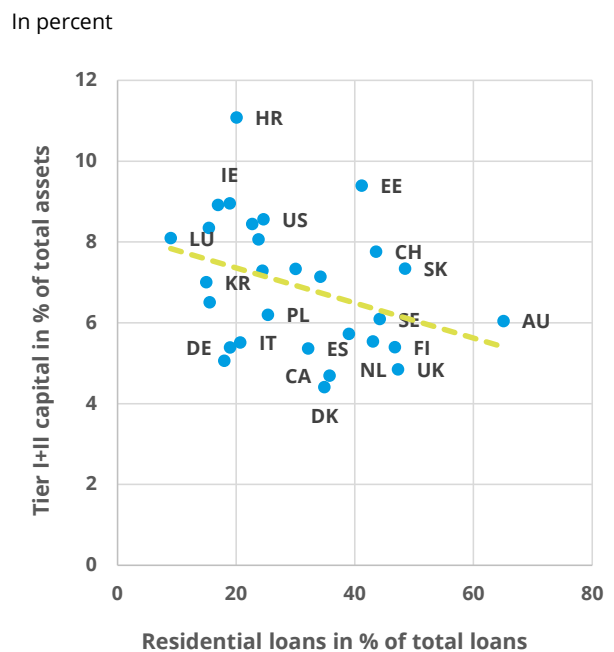


Sources: Federal Reserve Bank of New York, Refinitiv, Creditreform Rating

This also includes efforts to avoid shocks to financial stability. Risks to financial stability in advanced economies have increased as financial systems around the world are being put to the test by high inflation rates and associated monetary policy tightening.

Rapidly rising interest rates pose significant challenges to financial institutions and other market participants, who have raised their exposures to credit risk and liquidity and leveraged up to increase returns. This underscores the significance of flanking macroprudential measures, particularly for economies with large banking sectors and pronounced bank exposure to housing loans (see Figure 2).

Figure 2: High exposure to residential real estate sector tends to coincide with lower capitalization levels



Sources: IMF, Creditreform Rating

With fiscal support to alleviate high energy costs still largely in place and labor markets showing resilience, private consumption has partly held up better than expected. Investment remains supported by public funds to foster the digital and green transformation. Accordingly, the IMF slightly upgraded its global GDP growth forecast to 3.0% for 2023 in July, which is still modest and below both last year's outcome and the long-term average since 1980 (3.4%). Looking ahead to 2024, global GDP growth is expected to stagnate at 3.0%, whereas worldwide trade

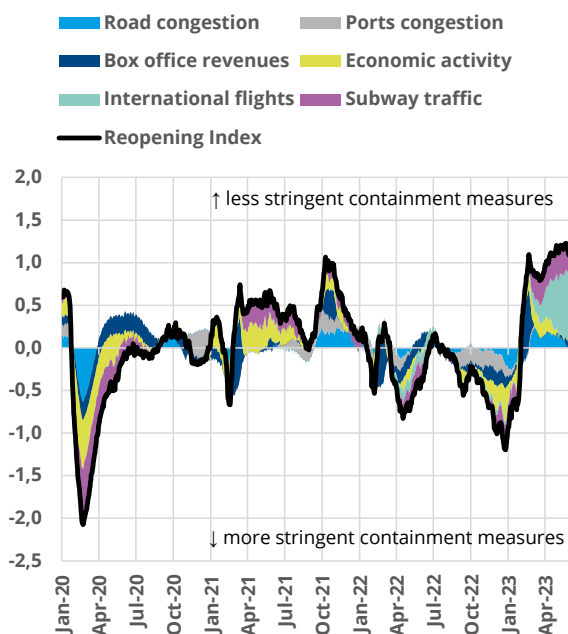
activities could see some acceleration. Partly reflecting ongoing downside risks to global trade flows from geopolitical fragmentation, forecasts for the growth rate of the global trade volume in 2023 have been revised down.

Chinese economy growing at limited speed

A key factor for this will be developments in China, where the economic pace appears to have moderated following the release of pent-up demand and a production boost after the lifting of the restrictive Covid-19 policies (see Figure 3). Downside risks relating to the real estate sector have increased significantly more recently, adding to a cautious outlook for the time being.

Figure 3: Transport logistics unlocked by China's abandonment of its restrictive Covid-19 regime

Contributions to China Reopening Index, a high-frequency indicator of the intensity of lockdown measures, in points



Sources: BIS, Creditreform Rating

Having expanded by a mere 3.0% in 2022, China's real GDP could increase by 5.2% this year and 4.5% in 2024 (IMF forecast), which would still compare as

tame with the pre-pandemic output growth, averaging 7.7% over the period 2010-19. Contrary to most other economies, inflation rates in China have been slightly negative recently, creating rather different challenges for the central bank than in many other regions at this stage, as deflationary pressure seems to become broader based. In June, the People's Bank of China lowered key interest rates for the first time since August 2022, followed by another cut this August, and there may be more to come.

United States: Fed shifts into fine-tuning mode

Having paused hiking its policy rate in June 2023 after ten consecutive increases since March 2022, and hinting at a slower pace of adjusting the fed funds rate, the Federal Reserve raised its main interest rate by another 25 basis points in July, to a target range of 5.25-5.50%. The door remains open for another hike in September, but any action remains highly data-dependent as the Fed pointed out. An episode of financial market stress this March, involving the resolution of two medium-sized, regional US banks, was met with effective action by US authorities including the Federal Deposit Insurance Corporations (FDIC) and the Federal Reserve.

While the US inflation rate has been retreating from its peak levels reached around the middle of 2022, the Fed considers its 2% target rate for the personal consumption expenditure (PCE) price index unlikely to be reached before 2025, according to the Federal Reserve Board's latest quarterly economic projections dating from June.

Consumer price inflation was at 3.2% in July (consumer price index for all urban consumers, CPI-U), with the core rate (excluding food and energy) significantly higher at 4.7%. While the US economy has been growing at a moderate pace, the labor market is showing signs of cooling, whilst continuing to post employment increases and a low unemployment rate. Unemployment stood at a low 3.5% in July, whereas the increase in non-farm payroll employment continued to ease. After rising by 187,000 in July, the three-month average increase of the respective employment level receded to 218,000 workers, down from 434,000 in July 2022. Nominal wage

growth and job vacancies have shown easing tendencies of late.

Real GDP growth should slow to about 1.8% this year and to 1.0% in 2024 (IMF, July 2023), as the cumulative effects of monetary policy tightening should work their way through the economy. Economic growth in the current year's first quarter turned out more robust than initially estimated, and preliminary estimates for Q2 2023 saw the economy expanding at an annualized rate of 2.4%. While more market participants now seem to see an increased chance for a soft landing, risks of the US economy falling into a deeper recession on the back of the aggressive tightening cycle are not off the table.

We now expect the Fed funds rate to be lifted one more time this year, to 5.50-5.75%, and we continue to think that a first rate cut will occur in Q1-24 at the earliest.

Kicking the can down the road – US debt ceiling suspended again

Initial failure of the main political parties to agree on lifting or suspending the statutory debt ceiling earlier this year, i.e. the total amount of money the US government is authorized to borrow to meet its existing legal obligations, was eventually resolved, avoiding any market disruption. The bipartisan agreement in June suspends the debt ceiling, previously set at USD 31.4 trillion, until January 2025. However, the frequency of political standoffs over this issue, combined with a high and likely rising debt levels, has added to risk perceptions as seen from a credit perspective.

2. Euro area

Resuming growth after a shallow technical recession

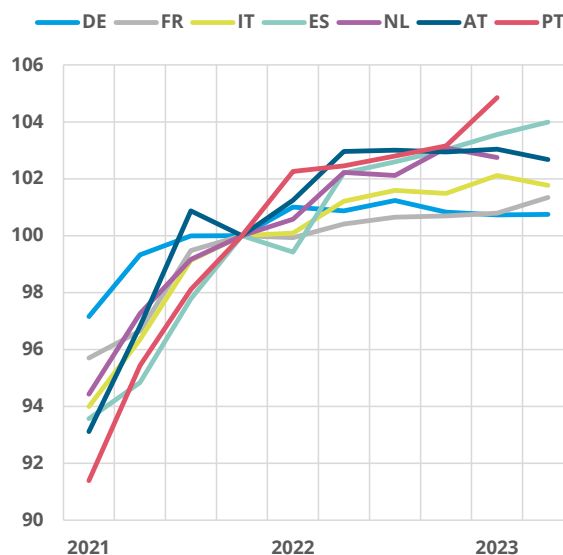
Following two consecutive quarters of contracting real GDP in the winter season 2022/2023, economic output in the euro area resumed growth in the second quarter, posting an increase by 0.3% q-o-q, according to preliminary Eurostat data. Developments

remain very heterogeneous, not least due to the energy mix and past dependence on Russia for energy imports, as well as due to a boost from normalizing tourism in a number of euro area countries.

Among the four major euro area economies, Germany saw the weakest performance since the second half of last year, with two consecutive quarterly declines in Q4-22 and Q1-23 and only stagnating real GDP in this year's second quarter, dragged down by weakness in Germany's important manufacturing sector (see [Figure 4](#)). Italy's performance is more volatile, with the economic output falling by 0.3% q-o-q the second quarter, following an increase by 0.6% in Q1-23. By contrast, after a period of near-stagnation, the French economy gathered some steam in Q2-23, expanding by 0.5% q-o-q, albeit somewhat exacerbated by a one-off effect in exports due to the delivery of a cruise ship.

Figure 4: German GDP growth trailing that of other major euro area economies

Real GDP in selected euro area economies, index (Q4-2021=100)



Sources: Eurostat, Creditreform Rating

In April 2023, we [affirmed France's long-term sovereign rating of "AA" with a negative outlook](#), with reasons for the latter mainly relating to fiscal prospects

including the public debt ratio. Key elements of the contested pension reform, which had led to widespread strikes earlier this year, were finally green-lighted by the French Constitutional Court, inter alia including a gradual increase in France’s legal retirement age to 64 years by 2030 and an increase in the minimum contribution period for full pension. If implemented as envisaged, the reform in our view could improve longer-term growth prospects as well as provide some relief in terms of age-related costs further out.

Spain recently outperforming the three largest euro area economies

Spain stood out positively among the four largest euro area economies over the last few quarters, showing comparatively robust growth rates, with recovering tourism remaining a strong driver. In our recent sovereign rating review (June 2023), we [affirmed Spain’s long-term sovereign rating of “A-” with a stable outlook](#). While its debt-to-GDP ratio remains one of the highest in the euro area, Spain is a front-runner in terms of disbursements of funds linked to the EU’s Recovery and Resilience Facility (RRF). This pays testament to significant progress in rolling out the reforms and initiatives set out in Spain’s Recovery, Transformation and Resilience Plan (RTRP), which we expect to markedly strengthen Spain’s underlying growth and to further enhance its economic resilience over the medium term.

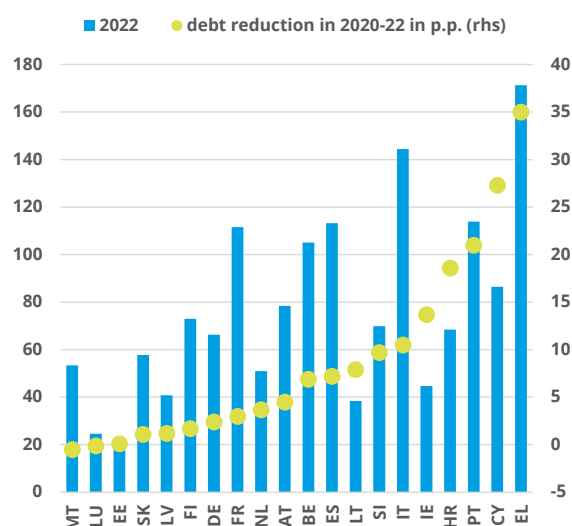
With regard to political developments, Spain’s parliamentary election on 23 July saw the center-right Partido Popular (PP) emerge as the strongest party, beating the governing Socialists (PSOE) with 136 seats to 122 in the 350-seat lower house of parliament. The right-wing VOX came third (33 seats), but a conceivable coalition of PP and VOX would still fall short of a majority, as would a coalition of PSOE and the left-wing Sumar (31 seats). The fragmented parliament may now pose some challenges to government formation, potentially leading to slower progress in implementation of RTRP measures.

Portugal upgraded to “A-” from “BBB”

More recently, we have [raised Portugal’s long-term sovereign rating to “A-” from “BBB”](#), reflecting ongoing progress, particularly with regard to improvements of the country’s macroeconomic and fiscal profile (see [Figure 5](#)), following a phase in the last decade during which the country had to seek financial assistance from its European partners.

Figure 5: Portugal displaying one of the steepest debt-to-GDP declines recently

General government gross debt in percent of GDP, debt-to-GDP reduction from 2020 to 2022 in percentage points



Sources: Eurostat, Creditreform Rating

The main reasons for the current upgrade were, firstly, buoyant economic growth, also driven by strong tailwinds from the tourism sector and the Portuguese economy’s resilience to the energy crisis, which has resulted in strong post-pandemic increases in per capita income. Secondly, we assess the outlook for solid medium-term real GDP growth as favorable, assuming topped-up EU financing and a timely implementation of the national Recovery and Resilience Plan (RRP). Thirdly, Portugal has repeatedly outperformed fiscal targets more recently, and the sovereign’s public debt ratio has seen a sharp decline coming on the back of Portugal’s robust macroeconomic backdrop and improving public

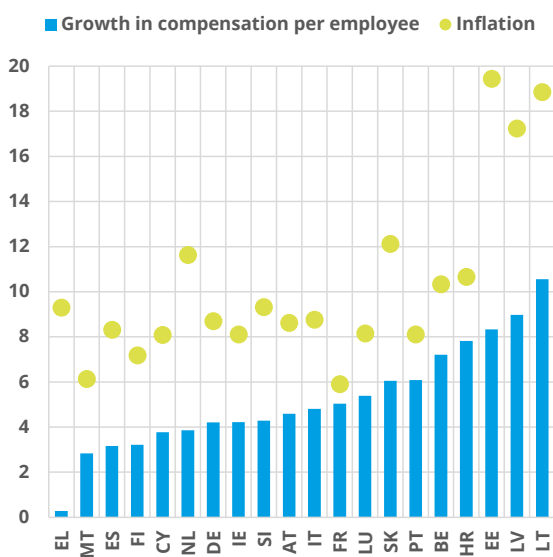
finances following the pandemic. We expect the debt-to-GDP ratio to follow a firm downward path over the medium term, whilst the banking sector should remain stable.

Euro area GDP growth to slow markedly in 2023, with limits set to the expected pick-up in 2024

Private consumption will likely pose a drag on euro area GDP growth this year, given its recent weakness. That said, prospects are improving on the back of retreating, although still elevated, inflation rates and still robust labor market developments, partly supported by ongoing fiscal support to households to alleviate the energy price shock. Having reached a low in the second half of last year, consumer confidence has been brightening over recent months. Tight labor markets, including shortages of skilled workers across a broad range of professions, are also translating into considerable wage increases, adding to expectations that private consumption will pick up as price pressures abate, which has held back real wage growth so far (see [Figure 6](#)).

Figure 6: Compensation growth trailing inflation, restraining real wage growth in 2022

Growth in nominal compensation per employee and annual HICP inflation rate in percent, 2022



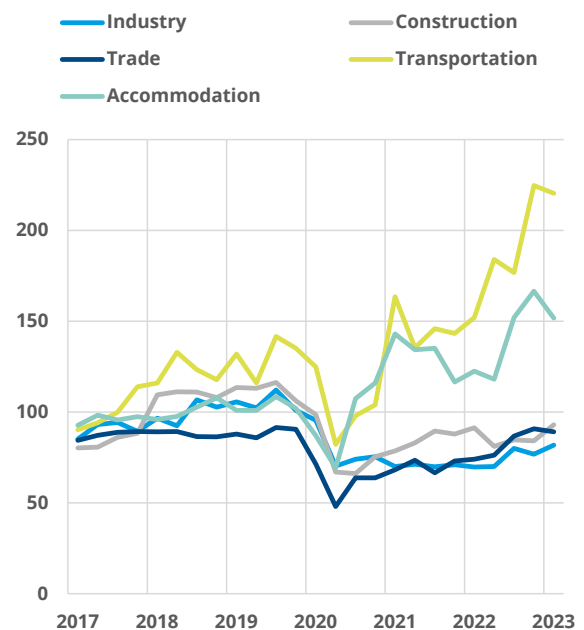
Sources: Eurostat, Creditreform Rating

Euro area unemployment has been stable on a relatively low level over the last few months, with the monthly unemployment rate standing at 6.4% as of June 2023. At the same time, the vacancy rate continues to move on a relatively high level, at 3.0% as of Q1-23. Having eased somewhat since the pandemic, labor shortages continue to pose challenges to a considerable share of businesses.

On the other hand, the cumulative effects from the ongoing monetary policy tightening should increasingly weigh on domestic demand, in particular on private investment. Public investment will continue to be backed by RRF-related funding to drive the digital and green transformation. In light of a mix of still high material costs, the higher interest rate environment and the likely gradual phasing out of government support measures, the focus will increasingly shift to corporate bankruptcies, which have seen only a moderate increase overall. However, a closer look reveals that in some industries the pressure has increased significantly (see [Figure 7](#)).

Figure 7: Pandemic and energy crisis ultimately taking their toll on exposed sectors

Bankruptcy declarations in the euro area (EA20), seasonally and calendar adjusted, index (2015=100)



Sources: Eurostat, Creditreform Rating

Furthermore, we expect net exports to make a positive contribution to total output expansion in 2023, while turning more or less neutral next year amid a stronger pace of private consumption and resulting higher import demand.

Overall, we currently expect euro area GDP growth to decelerate to about 0.9% in 2023, representing a slight upward revision compared to our last forecast. For 2024, we project an only slightly faster pace (1.1%), as monetary policy effects will exert a dampening effect and fiscal support measures are set to expire in 2023, partly offsetting relief from a lower level of energy prices and retreating inflation rates.

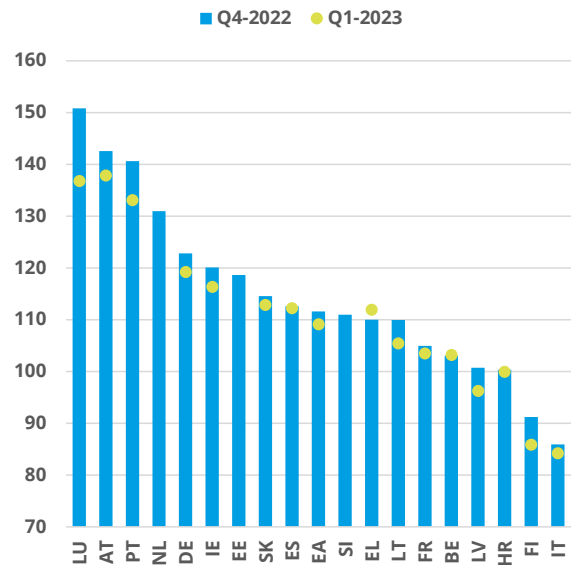
Our forecast is corroborated by latest leading indicators. After a slight improvement at the beginning of the year, the overall economic sentiment indicator for the euro area, which also includes consumer sentiment, has deteriorated over the spring months, pointing to slowing economic activity. In particular, sentiment in the manufacturing sector has weakened significantly in the course of the year, whereas sentiment in the service sector has held up better. The Purchasing Manager Index (PMI) for the euro area manufacturing sector fell for the sixth consecutive month in July, reaching a level deep in contractionary territory. The services PMI, which declined for a third month in a row, remained slightly above the 50-point mark, hinting at a moderate expansion of economic activity in the sector.

Risks to our euro area forecast remain skewed to the downside

Housing market developments will have to be monitored carefully as the risk of sharp price corrections remains in place. Residential real estate valuations are stretched in a number of countries, and housing affordability continues to remain under pressure in light of higher mortgage costs (see Figure 8). Moreover and closely related, we vigilantly monitor the evolution of mortgage lending and banks' respective portfolios, given the higher interest rate environment and potential difficulties of a larger share of households struggling to service their debt – essentially in economies featuring a high share in variable interest rate mortgages (see Figure 9).

Figure 8: House price valuations starting to ease somewhat from stretched levels

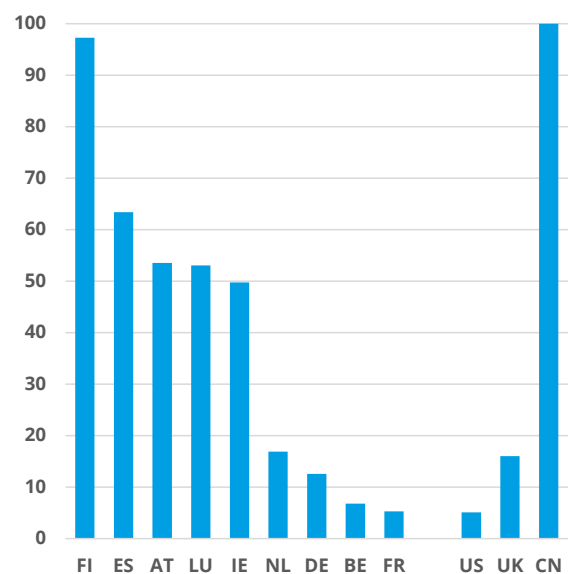
Ratio of real house prices to households' disposable income, respective quarter vs. average (Index 100=2010-19)



Sources: OECD, Creditreform Rating

Figure 9: Heterogeneous picture of banks' exposure to interest rate risks linked to mortgage lending

Adjustable rate mortgages in percent of total outstanding mortgages, average 2020-22



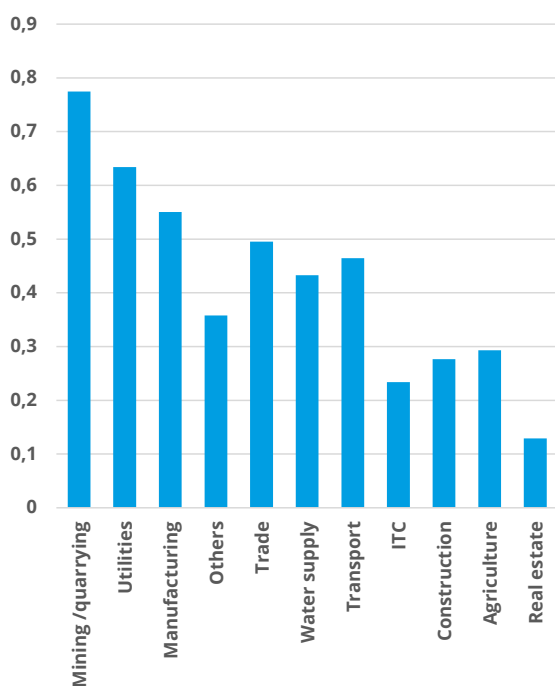
Sources: BIS, Creditreform Rating

At least judging by the latest EU-wide banking stress test published by the European Banking Authority this July, European banks should remain resilient even under an adverse scenario of a severe and global recession. This conclusion comes against the backdrop of a solid capital position of the sector overall.

Risks related to the war in Ukraine remain significant, including possible setbacks to sentiment and the real economy from potential new bouts of energy price rises or prices of other commodities sensitive to disruption.

Figure 10: Delayed green transition could prove particularly costly for several industries

Estimated increase in probability of default by sector in p.p., 2022-30



Sources: ECB, Creditreform Rating

In the absence of major shocks such as the outbreak of the pandemic and Russia’s military aggression against Ukraine, political risks may move more into focus in the euro area, given the challenges associated with partly ambitious aims in terms of greening the economy and related prioritization of policies

and fiscal means. Implementation of measures may not progress as planned, not least due to resistance among parts of society, which, however, comes with its own risks (see [Figure 10](#)). Other topics may come to the forefront as well, as the recent collapse of the Dutch governing coalition over agreeing on migration policies seems to show.

Lower headline inflation in the euro area, core rate sticky

Euro area inflation was down to 5.3% in July 2023, half the rate recorded in October 2022 (10.6%). Eastern European countries remain at the top of the range. Among the four major economies, Spain’s inflation rate sticks out as the lowest, standing at 2.1%, whereas the annual HICP in Germany remained above the euro area average at 6.5%.

Energy prices were still 6.7% higher than in July 2022, but the annual increase has slowed markedly. Food including alcohol and tobacco, which has a larger weight in the consumer price basket than energy, was a stronger driver, having seen an annual price increase of 10.8% in July 2023. However, excluding for energy and food, core price increases prove more persistent, running at a level 5.5% higher than last year. Services inflation has accelerated to 5.6% this July.

While second-round effects to price levels against the backdrop of strong wage remains a concern for the ECB, consumers seem to increasingly expect inflation rates to fall, as underscored by the European Commission’s respective monthly survey.

ECB becomes more hesitant amid a well-advanced hiking cycle

In its July meeting, the ECB Governing Council decided on another rate hike, by 25 basis points, lifting the marginal lending facility, main refinancing rate, and the deposit rate to 4.50%, 4.25% and 3.75%, respectively. The central bank has raised its key policy rates continuously since July 2022, but has now left the door open for a pause in September, depending on incoming data. By then, there may be stronger evidence that the recent downward trend in headline

inflation is firming. In its latest macroeconomic projections, dating from June 2023, the ECB forecasts the inflation rate to average 3.0% in 2024 and 2.2% in 2025. Projections for the core rate (excluding energy and food) largely corresponded to these levels for the coming two years.

We expect at least one more hike this year, while in our view a first rate cut will not occur until the second half of 2024. At this stage, we assume that the ECB's main refinancing rate should amount to 4.5% at end-2023 and 4.0% at the end of 2024. Admittedly, with regard to the unpredictable developments linked to the war in Ukraine, uncertainty remains high.

Meanwhile, the Asset Purchase Program portfolio is shrinking gradually, as principal payments from maturing securities are no longer reinvested since July 2023, while the ECB reconfirmed the reinvesting of maturing securities under the Pandemic Emergency Purchase Program (PEPP) until at least the end of 2024. On a side note, the ECB decided to end remunerating banks' minimum reserves.

3. Germany

Ongoing recession in the first half of 2023, dragging down our 2023 GDP forecast

In contrast to the other large euro area economies, the German economy has recently been in recession. Two consecutive quarter-on-quarter declines in real GDP of 0.4% and 0.1% in Q4-22 and Q1-23, respectively, were followed by stagnating total output in the second quarter, according to the flash estimate of the German statistical office. With that, expectations for a markedly brightening economic situation after the weak winter season were disappointed, despite receding energy prices. Strike action to push through higher wage demands and the associated lost working days are likely to have exacerbated the weak outcome to some extent in this phase.

While the detailed breakdown of the national accounts data is still pending, private consumption has

likely stabilized in this year's second quarter, following two consecutive declines. At the beginning of the year, private consumption was not only dragged down by high consumer prices, but also by falling car sales in connection with expiring or reduced subsidies for the purchase of hybrid and electric cars.

Gross fixed capital formation has been volatile over recent quarters. Taking a closer look on the breakdown, the recent weakness in construction investment strikes the eye, both in residential and non-residential construction. In addition to shortages of equipment and labor, higher costs and tightening credit conditions in the face of more restrictive monetary policy take their toll. Investment in machinery and equipment has held up better by comparison. Meanwhile, net exports contributed positively to GDP growth over the winter season, partly on the back of weak import activity.

Limping on the way out

Looking ahead, the weekly activity indicator compiled by Bundesbank indicates positive economic growth in the third quarter, while the ifo business climate index deteriorated for a third consecutive time this July, exhibiting a broad-based deterioration in sentiment, with the business climate in the construction sector even reaching its lowest level since February 2010. With the exception of the service sector, sentiment in the surveyed sectors is rather downbeat, meaning that a larger percentage of the participating businesses takes a pessimistic view.

Likewise, new manufacturing orders have been weak lately, suggesting that industrial production has been mainly carried by a still high, albeit decreasing, order backlog, the range of which fell to 7.2 months in May 2023. A lower stock of unfilled orders regarding car manufacturing was a main driver of the decrease of the order stock, while machinery and equipment contributed to a lesser extent.

Apart from dampening effects of the monetary policy tightening cycle and the persisting burden of high prices, economic sentiment is also affected by the political debate around and painful decisions linked to the aspired-to green transition, as the latter

comes with significant challenges. Among other things, there is uncertainty about a pending heating law and the associated costs, as, on the one hand, the conditions for investment in heating systems based on fossil fuels are likely to be significantly tightened, while, on the other hand, there will be stronger incentives for investment in heating systems based on sustainable energy. A surge in demand for systems based on sustainable energy sources threatens to overwhelm suppliers at this stage, while users of systems based on fossil fuels are concerned about the possible prospect of being forced to make costly changes in the foreseeable future.

Private consumption to become the main growth driver

That said, retreating energy prices and inflation rates seem to have had a positive effect on consumer sentiment, alongside ongoing fiscal support measures, wage increases and a still resilient labor market. Following a slight dip, consumer confidence stabilized in July, moving well above levels registered in the summer months of last year. Although the inflation rate has come down to 5.3% in July (HICP rate), with energy prices dropping by 6.1% compared to July 2022, it remains significantly above the 2% rate usually considered as being consistent with price stability. However, an expected ongoing decline towards this level should eventually give way to real wage increases.

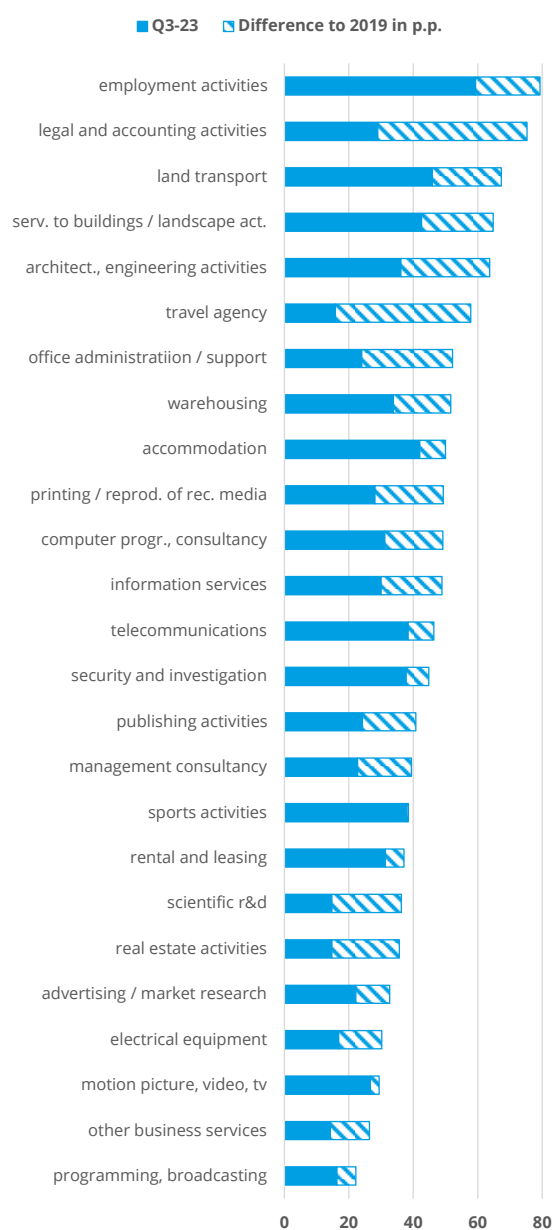
We thus expect private consumption to support GDP growth going forward. Having increased by 2.2% in 2022 overall, agreed earnings including extra payments in Germany rose by 2.7% in Q1-23. The hospitality sector saw a double-digit percentage increase, driven by considerably lifted regular pay rates. We expect average agreed earnings for the full year 2023 to be significantly stronger, as a number of new agreements across industries, including e.g. public services, have entered into force or will take effect in the course of the year.

Meanwhile, the German unemployment rate has remained stable at a very low 3.0% over the last few months (LSF-adjusted). Quarterly employment growth has continued, despite having moderated

somewhat compared to last year. In Q1-23, job creation was 0.7% higher than a year earlier. Having said this, labor shortages remain pervasive, above all in the service sector (see Figure 11).

Figure 11: Labor shortages in the services sector have intensified since the pandemic

Firms reporting labor shortages as a factor limiting production, in percent of total firms surveyed, 2019 as unweighted mean of Q1-Q4



Sources: Eurostat, Creditreform Rating

Also, hiring intentions have decreased more markedly in July, drawing on the monthly ifo employment barometer, especially in manufacturing, underscoring the overall more cautious stance of businesses. Expectations for employment growth in the service sector remain at least positive. In a bid to address the shortage of skilled labor, a law aimed at facilitating the immigration of qualified foreign workers will gradually come into effect from November 2023, lowering the entry bar e.g. for IT specialists and health workers.

Perspectives for construction investment appear rather muted for the time being, while the outlook for investment in machinery and equipment is somewhat brighter, given the expected recovery of private consumption and some impulses from external demand. Public investment should remain supportive, against the backdrop of efforts to drive the twin transition. To be sure, export expectations in the manufacturing sector have become more pessimistic over the three months to July, judging by the respective ifo indicator, suggesting that any positive contribution from net exports this year is likely to be small.

Overall, we have lowered our GDP growth forecast for Germany to -0.1% due to the weaker than expected development in the first months of 2023. For the coming year, we expect real output to expand by about 1.0%, chiefly driven by private consumption and only to a small extent by investment. With exports facing headwinds from the cumulative adverse effects of tighter monetary policy on domestic demand in Europe and the US, we think that net exports will exert a drag on GDP growth in 2024.

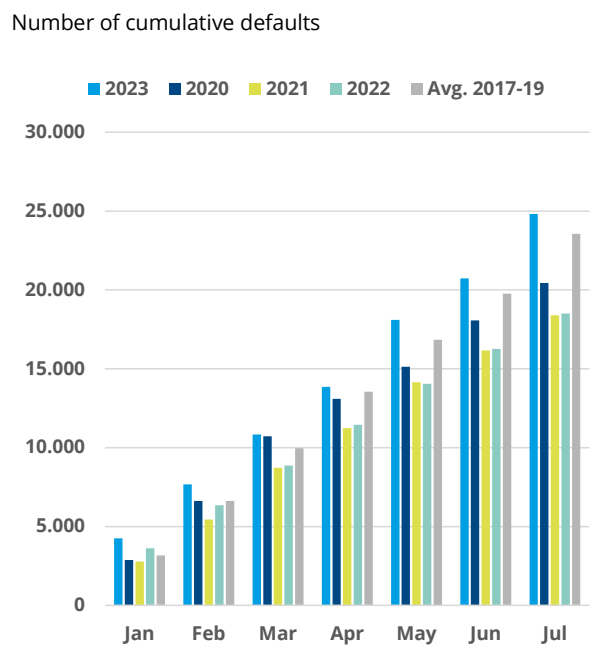
There is still a high level of uncertainty surrounding these forecasts due to unpredictable events related to the war in Ukraine. While this also applies to potential new spikes in energy prices, or sharp increases in prices of other commodities, there are indications that the bill for fiscal support associated with the gas price brake may not be as high as initially assumed, thanks to the significant decline in energy prices in recent months. According to current estimates by the German ifo institute, only about one third of the amount originally earmarked by the

government (EUR 40.3bn) may need to be used this year.

Creditreform data: Business default rates continue to rise

The default rate of German companies is currently increasing significantly, after having fallen continuously in 2010-21 (from 2.23% to 1.08%). Between 2021 and 2022, it rose to 1.17%, still below the pre-pandemic level of 1.36%. More recently, the situation has deteriorated further against the backdrop of the energy crisis. At the end of the first half of 2023, the share of defaulted companies increased by 0.17 percentage points to 1.34% (see [Figure 12](#)).

Figure 12: Successive crises and tighter financing conditions ultimately eroding corporate resilience



Source: Creditreform Rating

We measure corporate default rates based on a Basel-compliant definition of the default event, which not only includes corporate bankruptcies but also payment delays of more than 90 days. The results are empirical default rates rather than extrapolations or estimates, due to our comprehensive data-

base of approx. 2.4 million economically active companies, which is equivalent to a complete survey of the German corporate sector.

We expect the number to drift upward over the coming months, in an environment shaped by increasing challenges in terms of costs of debt-servicing and higher costs of new loans.

Pleasure and pain of a higher interest rate environment

While the banks generally benefit from the rising interest rates in terms of profitability, macroprudential levers have been activated to build buffers against the aforementioned risks. Since February 2023, a countercyclical capital buffer and a capital buffer for systemic risks associated with residential real estate loans have to be applied. Looking at the ECB's July Bank Lending Survey, German banks have again tightened their credit standards for loans to enterprises and households both with regard to house purchase and to consumer/other credit, in Q2 2023. That said, net tightening appears less broad-based by now (see Figure 13). Moreover, the responding banks do not expect to tighten standards to a meaningful extent over the next three months.

Underscoring the dampening effect of higher interest rates, loan demand was reported to have diminished in all three loan categories (enterprises, consumption, housing), although household demand for mortgages now seems to be decreasing at a less pronounced rate. Apart from tighter financing conditions, declining fixed investment was reported to be another major factor throttling loan demand among enterprises.

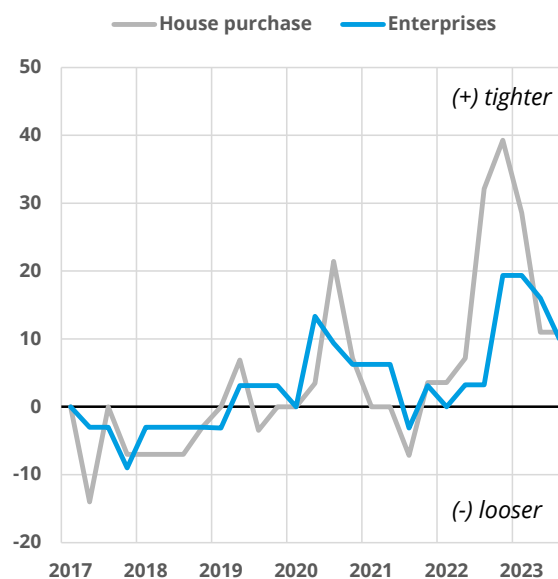
Judging by the replies to an ad-hoc question in July's survey, the most pronounced tightening of credit standards for loans to enterprises over the past six months occurred in the real estate sector, which is consistent with the findings as regards the steepest reported decline in loan demand. Apart from real estate, the construction and the energy-intensive manufacturing sectors saw comparatively strong tightening of credit standards.

As a side note, and emphasizing the growing awareness and importance of Environmental, Social and

Governance (ESG) issues, respondent banks plan to tighten their credit standards for loans to enterprises more strongly in connection with the impact of climate change.

Figure 13: Net tightening of credit lending standards continues, but to a less pronounced degree

Lending survey among German banks, net percentage: frequency of tightened minus that of eased credit standards



Sources: Deutsche Bundesbank, Creditreform Rating

House price dynamics in backward gear

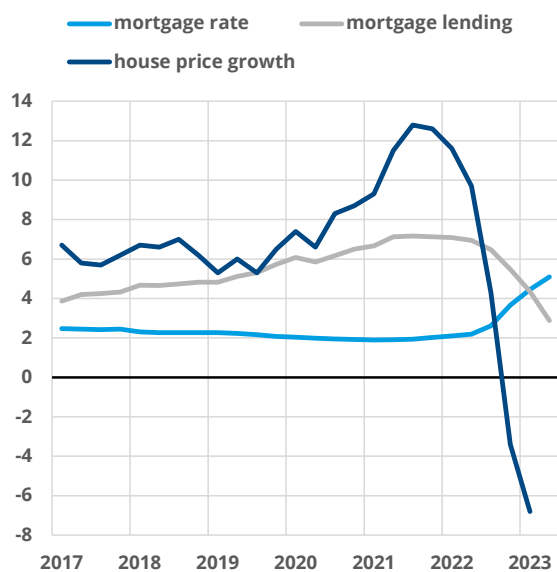
While lending to residential real estate has slowed, so have house price dynamics, although from high levels (see Figure 14). A number of price indices point to declining house prices by now. Drawing on Eurostat data, German house prices have dropped by 6.8% as of Q1 2023 compared to the first quarter of 2022. Affordability indicators such as the OECD's price-to-income ratio still point to overvaluation (see above).

We expect property prices to continue to moderate this year. Whilst more abrupt movements remain a possible risk scenario, supply and demand fundamentals could prevent this risk from materializing in many regions. According to the German statistical office, 295,300 new dwellings were completed last

year, missing the government's target of 400,000 per year. As in 2022, insufficient capacities, higher costs and bureaucratic obstacles are likely to prevent the government's target from being reached in 2023. The number of building permits in 2022 fell by 7.0% to 354,200 compared to the previous year, but remained significantly higher than the number of completed dwellings, increasing the backlog of approved but uncompleted dwellings to 884,800 by the end of 2022.

Figure 14: Higher costs affecting demand drags on house prices in Germany

Y-o-y growth of quarterly residential property prices in percent, y-o-y growth in outstanding volume of mortgages, MFI interest rate lending for house purchase in percent (annualized agreed rate, original maturity/fixation period up to 1 year)



Sources: ECB, Eurostat, Creditreform Rating

4. United Kingdom

Lackluster economic activity in the first half of 2023

The UK economy has undergone a phase of pronounced weakness recently, although it did not exhibit a technical recession. Nevertheless, its real GDP expanded by only 0.1% q-o-q in Q4-22 and Q1-23 respectively. This year's second quarter saw a slightly faster pace of quarterly GDP growth (0.2%), with private consumption and government consumption contributing positively, whereas gross fixed capital formation did not grow and net exports posed a drag. The outcome could have been slightly stronger, had it not been for an exceptional bank holiday due to the coronation of King Charles III in May, which likely slowed down overall economic output somewhat. Since the outbreak of Covid-19, the UK GDP has not yet surpassed its level registered prior to the pandemic (Q4-19).

Looking at the growth breakdown by production components, manufacturing was a main driver in this year's second quarter, in particular manufacturing of transport equipment. According to the Office for National Statistics (ONS), 8 out of 13 manufacturing sub-sectors recorded increases in Q2, likely due to decreasing input prices. Construction output rose by more than output in the services sector.

Little acceleration over the remainder of the year

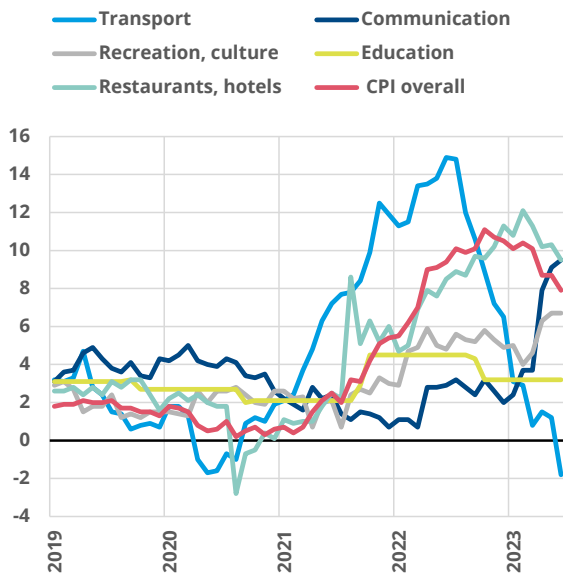
With a view to current business climate indicators, there are few signs of a major acceleration in the current quarter. The picture for the monthly PMIs remains mixed, with the respective gauge for the sentiment in the services sector pointing to a more moderate rate of expansion in July, while the PMI for the construction sector is back in expansionary territory and the manufacturing PMI remains well below the 50-points mark in contractionary territory. Having seen a recovery from a comparatively subdued level over recent months, consumer confidence captured by the respective GfK indicator experienced a setback this July. The monthly GDP tracker provided by

the National Institute of Economic and Social Research suggests that GDP could expand by 0.3% in Q3-23 against the preceding quarter.

While households' income remains squeezed by high inflation rates, ongoing strike action in parts of the public sector may additionally weigh on economic output to some extent, although assumed eventual pay rises should allow private consumption to gain some traction. The UK labor market remains tight, adding to upward pressure on wages, which seems to be feeding through to persistent price pressures in services (see [Figure 15](#)).

Figure 15: Few exceptions to broad-based upward pressure regarding service inflation

Consumer price inflation, annual rates in percent, 2015=100



Sources: ONS, Creditreform Rating

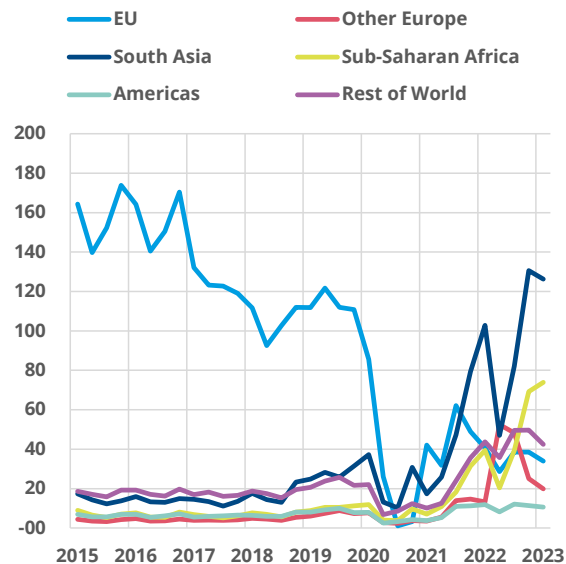
That said, there are signs of cooling: The unemployment rate rose to 4.3% in the three months to June 2023, continuing to compare low in the European context. At the same time, total employment may have passed its peak recently. In the three months to June, it decreased slightly. Apart from that, a noteworthy development, as pointed out by the August Report on Jobs by KMPG and REC, concerns a stronger rise in availability of staff, which appears to

be chiefly driven by redundancies. Concurrently, permanent hires saw an accelerated decline, adding to hints that the lackluster economic development and subdued outlook are starting to take a greater toll on the labor market. While the report also included some signs of abating pay pressure, it also highlighted ongoing strong growth in permanent salaries.

Focusing on structural labor market developments in the post-Brexit regime, non-EU employees have increasingly entered the labor market and increasingly make up for declines of the EU workforce in a number of sectors (see [Figure 16](#)). In 2022, the number of non-EU workers exceeded that of EU workers for the first time.

Figure 16: Brexit-effect is being made up for by increasing number of non-EU workforce

Thousands, national insurance number registrations by immigrants



Sources: Department of Work and Pensions, Creditreform Rating

Sharp monetary policy tightening weighs on growth outlook

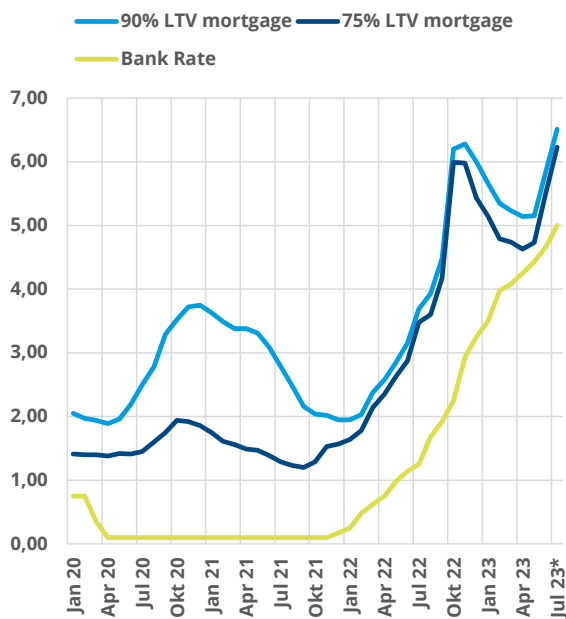
Looking ahead, and assuming that the drag posed by energy prices continues to fade, we expect private

consumption to become a main motor of a moderate acceleration of economic growth, although steep increases in mortgage costs are likely to constrain household expenditure (see [Figure 17](#)).

In the same vein, a significant stimulus from foreign demand appears unlikely over the coming months. Given the increasingly dampening effects of ongoing monetary policy tightening in Europe and the US. Moreover, the expiry of investment incentives (super-deduction) and an increase in the corporation tax rate from 19% to 25% this April add to cost pressure and hiring challenges in light of skill shortages, thus likely continuing to weigh on business investment in the near term. On top of these challenges, higher interest rates on the capital market have pushed up rates on new business loans. Judging by the monthly Decision Maker Panel, capital expenditure could be negative over the next year.

Figure 17: Central bank tightening passed on to borrowers

Average quoted rates on two-year fixed-rate mortgages, Bank of England key policy rate, monthly averages, *) preliminary



Sources: Bank of England, Creditreform Rating

Given the described headwinds to both domestic and external demand, we expect real GDP to expand only moderately by 0.5% in 2023 overall, which however corresponds to an upward revision of our latest projection, due to a less weak result over the winter half 2022/2023. As monetary policy is likely to tighten further, and the cumulative effects of this more restrictive stance are set to slow economic activity over the coming quarters, we revised our UK GDP forecast for 2024 to 0.8%.

With its peak behind it, the CPI inflation rate stood at a still high 6.8% in July 2023, although down from double-digit figures observed through March 2023. Exceeding the headline inflation rate, the core rate (excluding energy, food, alcohol and tobacco) remained at 6.9% and has been trending higher, prompting the Bank of England to tighten its grip even firmer, as perceived second-round effects may take longer to unwind. Annual growth in private sector regular average weekly earnings increased to 8.2% in the three months to June 2023, from 5.4% a year earlier.

Monetary policy: Higher interest rate for longer, with risks attached

Since our last Economic Briefs (March 2023), the Bank of England’s Monetary Policy Committee (MPC) has continued to increase its Bank Rate in May, June and August, taking markets by surprise by voting for a large step (50 basis points) in June to rein in rising inflationary dynamics. In August, MPC members voted by a majority of 6–3 to increase Bank Rate by another 0.25 percentage points, to 5.25%. Two members preferred an increase by 0.5 percentage points, one member voted to maintain the rate at 5.0%.

The MPC expects the CPI inflation rate to return to its 2% target by the second quarter of 2025, and to fall below the target in the medium term. The projection has been raised from May 2023, and risks around the forecast are considered to be on the upside, mainly due to possibly stickier second-round effects. We now expect the Bank of England’s key policy rate to reach a peak at 5.75% later this year. A first rate cut

looks unlikely to occur before the second half of 2024.

The reduction of the Asset Purchase Facility (APF) portfolio began in March 2022. At approx. GBP 804bn, the portfolio size has been reduced by about 10% since its peak at the turn of the year 2021/22. At its September 2023 meeting, the MPC will hold its annual review and vote on the target for gilt stock reduction over the 12-month period from October 2023 to September 2024.

House price growth has slowed considerably by now, with the annual rate of the HM Land Registry's UK house price index for all types of property falling from 6.4% in June 2022 to 1.7% in June 2023. By the same token, sales volumes have declined markedly. Drawing on HMRC data on the number of residential transactions, these were 9% lower in June 2023 compared to June 2022. We expect these downward trends to continue, with further increases in mortgage rates likely to deter a greater number of potential buyers in the near term, which should be reflected in outright annual house price declines going forward.

While potentially more abrupt price corrections could pose risks to financial stability, possibly in tandem with more pronounced difficulties of private households to service their debt, the results of the recent UK bank stress test published this July suggested that major UK banks seem resilient to a severe stress scenario.

Less political noise

Political noise has calmed down following a turbulent phase yielding three prime ministers in quick succession last year. The somewhat strained relationship with the EU seems to have improved since then, not least resulting in the Windsor Agreement this February. More recently, there has been some progress on a possibly closer cooperation between the UK and EU on financial services in the post-Brexit environment, with the signing of a Memorandum of Understanding to establish an ongoing forum to dis-

cuss regulatory matters of mutual interest, potentially reducing current vulnerabilities linked to this issue further out.

Figure 18: Our forecasts for European major economies are somewhat less optimistic for 2024

In percent, IMF forecasts for World, China, US

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

Sources: Creditreform Rating, IMF

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