



DIW Economic Outlook Winter 2023

305 Report by DIW Berlin's Economic Forecasting Team

**DIW Berlin Economic Forecast:
Forecast ranges from cloudy to bright**



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German economy trudging through 2023; budget cuts to dampen recovery from 2024



LEGAL AND EDITORIAL DETAILS



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AT A GLANCE

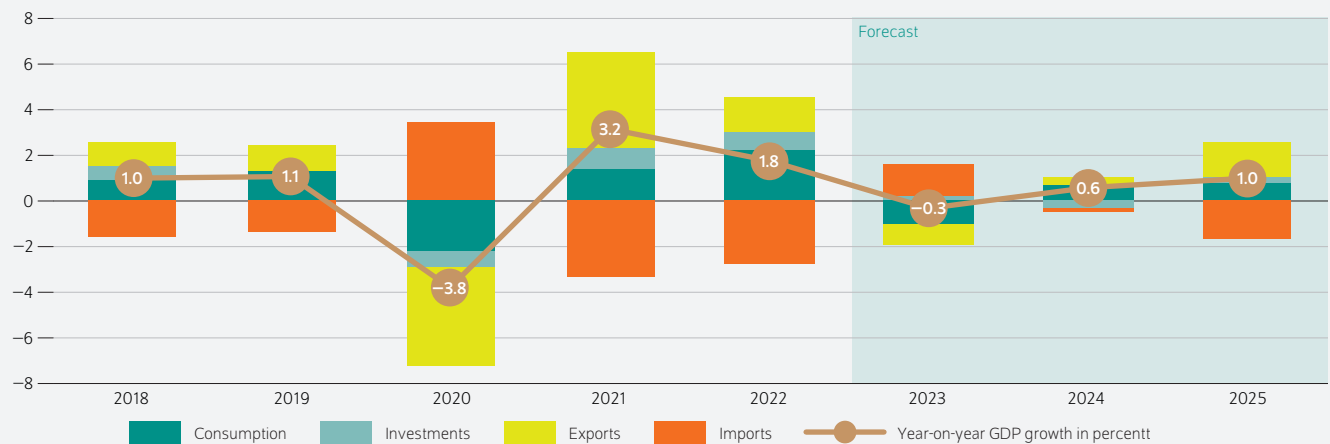
DIW Berlin Economic Forecast: Forecast ranges from cloudy to bright

By DIW Berlin's Economic Forecasting Team

- Recovery of the German economy is becoming an exercise in patience: private consumption and economic output recently declined
- Considerable uncertainty due to the reorganization of the federal budget; it is assumed that primarily investment funds will be cut
- Following a 0.3 percent decline in 2023, the German economy is likely to grow by 0.6 percent in 2024; however, this is half of the autumn forecast
- Uncertainty and the loss of public funds due to the Federal Constitutional Court ruling will reduce growth by 0.3 and 0.2 percentage points in 2024 and 2025
- Global economy remains robust: Following 4.1 percent growth in 2023, economic output is expected to grow by 3.7 and 3.9 percent in 2024 and 2025

The German economy will only experience a moderate upswing in the forecast period

Individual GDP components' contribution to growth in percentage points



Source: DIW Berlin Economic Outlook Winter 2023.

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FROM THE AUTHORS

"Inflation has recently fallen more than was expected at the beginning and in the middle of the year. We will still have a slightly elevated level of inflation in 2024, but it will then move relatively quickly towards the European Central Bank's two percent target."

— Timm Bönke —

MEDIA



Audio Interview with Timm Bönke (in German)
www.diw.de/mediathek

DIW Berlin Economic Forecast: Forecast ranges from cloudy to bright

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EXECUTIVE SUMMARY

The recovery of the German economy is becoming an exercise in patience. In the third quarter of 2023 the economy fared worse than expected, in particular because private households continued to spend their money conservatively despite climbing wages and falling inflation. Both private consumption and overall economic output even declined slightly. Now the next challenge has arrived: In November 2023, the German Federal Constitutional Court ruled that the reallocation of unused coronavirus pandemic funds to the *Klima- und Transformationsfonds* (KTF) is unconstitutional. This ruling has far-reaching consequences for public budget and thus also for economic development in Germany.

This forecast is based on the assumption that funds will be cut, particularly for investments, with the necessary cutbacks amounting to around 19 billion euros in 2024 and 2025 each, eleven billion euros in 2026, and three billion euros in 2027. There is also considerable uncertainty surrounding the reorganization of the budget. The assumed cuts to public funds underlying this report were made before a budget deal was reached on December 13, but correspond in structure and scale to the consolidation proposals of the government. The Federal Government quickly suspended the debt brake again for 2023 by declaring a state of emergency. In the 2024 federal budget, the Federal Government primarily agreed to around twelve billion euros' worth of cuts to subsidy programs and corporate compensation from the KTF and a minor carbon price increase of five euros. The 2024 budget also preserves the EEG surcharge and the heating program as part of the

Building Energy Act. A further 17 billion euros are to be generated through cuts to the core budget.

DIW Berlin expects a 0.3 percent decline in economic output for 2023. The German economy is expected to grow by 0.6 percent in 2024 and by 1.0 percent in 2025. Thus, the economic recovery will be much slower than was expected according to the DIW Berlin autumn forecast. The cancellation of public funds and the uncertainty resulting from the Federal Constitutional Court's ruling will reduce growth by 0.3 percentage points in 2024 alone. Overall, the forecast was downgraded by 0.6 percentage points compared to autumn, as, in addition to the ruling and its consequences for investment activity, private consumption is struggling to find momentum.

The global economy remains robust. With the exception of China, both advanced and emerging economies have recently experienced solid growth. Economic output is still weak in the euro area and the United Kingdom. However, falling inflation rates will increasingly strengthen real wages in these countries, which should support purchasing power in 2024. Due to the gradual recovery in Europe as well as China and a cooling economy in the United States, global economic growth will be somewhat lower in 2024 at 3.7 percent.

The global economy is surprisingly robust; euro area growth to pick up in spring 2024

The global economy has been surprisingly robust over the course of 2023, especially the US and Japanese economies. While high inflation was still weighing on demand at the beginning of 2023, the central banks of most advanced economies have now reached the end of their interest rate hikes. Falling inflation rates have strengthened real wages, which should support purchasing power in 2024. With the exception of the faltering Chinese economy, the emerging economies are growing.

The global economy expanded by 0.9 percent in the third quarter of 2023, slightly more than the 0.8 percent growth in the second quarter. Growth in the advanced economies has been just as strong as in the emerging economies (Figure 1). The US economy in particular experienced strong growth rates of 1.3 percent. Surprisingly, US consumers have expanded their consumption considerably, likely due to remaining excess savings and steadily falling inflation rates. Economic output in the euro area, in contrast, remained weak in the third quarter. The euro area economy contracted slightly by 0.1 percent; only Spain stands out from the other Member States with slower but relatively strong growth of 0.3 percent. GDP stagnated in the United Kingdom and shrunk in Japan due to declining domestic demand (minus 0.5 percent) following a strong economic expansion in the first half of 2023 due to considerable export and tourism growth.

The Chinese economy grew by 1.3 percent after expanding by only 0.5 percent in the second quarter. However, the unresolved real estate problems in China continue to weigh on its economy. Other major emerging economies, such as India and Mexico, experienced quite robust GDP growth. In Brazil, in contrast, there are signs that the economy is cooling down, at least temporarily, after strong harvests and exports drove growth in the first half of 2023. The GDP of EU Member States in Central and Southern Europe also experienced strong growth (Table 1).

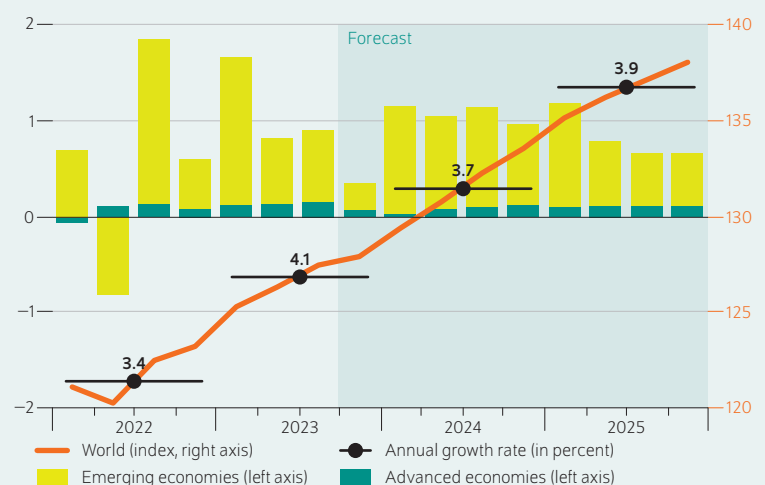
Industrial output and retail sales have developed modestly in the advanced economies over the past months. The Purchasing Managers' Index, especially for industry, has remained significantly below or near the expansion threshold of 50 in many places, although the values in the euro area and the United Kingdom are lower than in other advanced economies. The outlook for the services sector is somewhat better: Falling inflation rates are likely to support real wages and thus provide a slight boost to private household consumption.

In the current fourth quarter, restrictive monetary policy in many places and sluggish foreign demand continue to weigh on advanced economies. In the United States, for example, growth will likely slow significantly to 0.4 percent following two consecutive quarters of robust expansion. For the time

Figure 1

Growth of real GDP

Quarter-on-quarter percentage growth (left axis); index 2015 Q1 = 100 (right axis)



Sources: National Statistical Offices; DIW Berlin Economic Outlook Winter 2023.

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After a weak end to the year, the global economy should pick up speed again next year

being, there is no notable upswing in sight for the euro area or the United Kingdom, each of which will likely grow by only 0.1 percent. The Japanese economy is also likely to experience only moderate growth of 0.2 percent.

Most emerging economies should continue to expand in the fourth quarter; only China, with expected growth of 0.2 percent, will end 2023 on a weak note. However, the fiscal policy measures implemented by the Chinese government in October offer hope for 2024; this could mean that the economic slump has bottomed out. The Indian economy has been quite robust thanks to strong domestic demand, while the Mexican economy is benefiting from the efforts of US companies to shift production and the purchase of advance services away from China.

International trade experienced weak growth in 2023: It declined by 0.2 percent in the second quarter compared to the first and by 1.0 percent in the third quarter compared to the second. Geopolitical conflicts as well as the global economy's moderate expansion are likely to result in international trade only increasing slightly during the forecast period. In many places, the supply situation is much more relaxed than before the pandemic. This should also lead to

Table 1

Real GDP, consumer prices, and unemployment rates in the global economy

In percent

	GDP				Consumer prices				Unemployment rate in percent			
	Year-on-year percentage change											
	2022	2023	2024	2025	2022	2023	2024	2025	2022	2023	2024	2025
Europe												
European Union	3.5	0.5	1.2	1.7	9.2	6.4	3.2	2.4	6.1	6.0	6.1	5.9
Euro area	3.4	0.5	0.9	1.4	8.4	5.4	2.8	2.1	6.7	6.5	6.5	6.4
excluding Germany	3.9	1.1	1.1	1.5	8.0	5.2	3.1	2.1	8.5	8.2	8.2	8.0
France	2.5	0.9	1.2	1.4	5.9	5.6	2.9	2.0	7.3	7.3	7.4	7.3
Italy	3.9	0.7	0.6	1.0	8.7	6.1	2.9	2.2	8.1	7.7	7.7	7.7
Spain	5.8	2.4	1.6	2.0	8.3	3.5	3.7	1.9	12.9	12.1	11.5	11.1
Netherlands	4.4	0.2	1.1	1.9	11.6	4.3	3.4	2.4	3.5	3.6	3.9	3.8
United Kingdom	4.3	0.5	0.7	1.4	9.1	7.3	2.9	2.2	3.7	4.1	4.6	4.8
Switzerland	2.7	0.8	1.5	1.9	2.8	2.2	1.3	1.2	4.3	4.1	4.4	4.4
Central and Eastern Europe	4.8	0.6	2.7	3.3	13.5	11.9	5.1	3.5	3.5	3.5	3.4	3.2
Turkey	5.3	3.3	3.3	3.2	72.3	52.7	47.9	39.0	10.5	9.5	9.5	10.0
Russia ¹	−1.3	1.8	1.0	1.4	13.8	5.7	6.0	4.6	3.9	3.2	3.2	3.2
The Americas												
USA	1.9	2.5	1.6	1.7	8.0	4.1	2.0	1.8	3.6	3.7	4.1	4.0
Mexico	3.9	3.1	1.7	2.2	7.9	5.4	3.2	2.8	3.3	2.9	3.4	3.6
Brazil	3.1	3.1	1.6	2.1	9.3	4.6	3.4	2.9	9.5	8.3	10.6	14.8
Asia												
Japan	0.9	1.7	1.2	1.1	2.5	3.0	1.9	1.4	2.6	2.6	2.6	2.5
South Korea	2.6	1.3	2.2	2.4	5.1	3.5	2.3	2.0	2.9	2.8	3.2	3.2
China	3.0	5.3	4.7	4.5	2.0	0.5	1.6	2.1	5.6	5.2	5.1	5.1
India	6.6	6.8	6.1	6.3	6.7	5.9	5.6	4.1	7.6	7.6	7.2	7.4
Total												
Advanced economies	2.4	1.5	1.1	1.4	7.4	4.6	2.1	1.7	4.4	4.4	4.6	4.5
Emerging economies	3.8	5.0	4.6	4.6	9.1	5.0	4.0	4.1	6.3	6.0	6.0	6.4
Global economy	3.4	4.1	3.7	3.9	9.1	5.5	4.3	4.3	5.9	5.6	5.7	6.0
For reference:												
Export weighted ²	2.6	2.1	1.7	2.0								
GDP weighted in USD ³	3.5	3.0	3.1	3.3								

1 The data forecast for Russia are subject to major uncertainties. Russia has only minor weight in the overall forecast.

2 World weighted with shares of German exports from 2022.

3 World weighted with the GDP in USD from 2022 to 2025.

Notes: The black figures are finalized. The values of the country groups are calculated as a weighted average, whereby the respective GDP in purchasing power parities from the IMF World Economic Outlook for 2022 to 2025 is used to weight GDP and consumer prices. The 2022 labor force (15–64 years old) figures of the respective countries are used to weigh the unemployment rate. Central and Eastern Europe consist of Poland, Romania, Czechia, and Hungary.

Sources: National Statistical Offices; DIW Berlin Economic Outlook Winter 2023.

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lower import prices for non-energy goods and thus support falling inflation.

Most central banks in the advanced economies are now likely to have reached the end of their interest rate hikes. Inflation rates have fallen sharply in many places in recent months and core inflation rates have also begun to fall. However, monetary policy in many advanced economies, except for Japan, will remain restrictive. Average inflation over 2023 will still be considerably above the target of the respective countries' central banks in most of the advanced economies. Inflation will likely start approaching the targeted rates in 2024: Beginning in early summer 2024, interest rate cuts are first expected in the United States and later in the euro area. In Japan, there has recently been a series of announcements that monetary policy is slowly moving away from its very accommodative

stance. The gap between the low interest rates in Japan and the very high interest rates of the central banks of other advanced economies has caused the yen to lose around 25 percent of its value against other major currencies since 2020.

Monetary policy is no longer restrictive in many emerging economies. In Brazil, the interest rates have been lowered three times since the beginning of August in response to the weakening economic situation. Currently, there is no price pressure in China. However, issues in the Chinese real estate sector are dampening consumer spending as well as inflation. The global stock markets performed surprisingly robustly in 2023. The S&P 500 in the United States has risen by almost 19 percent since January 2023, while the EuroStoxx 50 has increased by 12 percent.

Fiscal policy will provide some stimuli in the forecast period: At the beginning of November, the Japanese government announced a massive stimulus package to alleviate the burden on households due to high inflation. The program is worth the equivalent of 103 billion euros, or three percent of Japan's GDP. The United Kingdom also passed further fiscal policy measures in autumn. In other advanced economies, medium-term investment packages will provide stimuli.

No comprehensive fiscal packages are expected in the emerging economies due to still-high interest rates. China is the exception: In view of its weakening economy, the Chinese government announced a plan in October to issue the equivalent of 128 billion euros (0.8 percent of GDP) in government bonds by the end of 2023.

With the expected interest rate turnaround in the advanced economies in early summer 2024 and the fiscal stimuli in China and Japan, the global economy is likely to experience solid growth in 2024 (Table 1). The significant decline in headline inflation is also likely to lead to more increases in real wages in the euro area from 2024, which should boost household purchasing power. Falling interest rates should additionally support residential construction and corporate investments in the second half of 2024. In 2025, most economies will likely continue recovering considerably in light of falling inflation rates, with the emerging economies generally expected to perform better than the advanced economies. In China, however, the outlook remains reserved.

On average, the advanced economies, despite meager growth in the euro area and the UK, will expand by a solid 1.5 percent

in 2023. Economic output will likely increase by 5.0 percent in the emerging economies. All in all, the global economy should grow by 4.1 percent in 2023. Thus, DIW Berlin's winter forecast deviates from its autumn forecast by only 0.2 percentage points. The global economy will increase by 3.7 percent in 2024 and by 3.9 percent in 2025, each 0.2 percentage points less than in the autumn forecast.

This forecast is based on several uncertainty factors, most of which represent downside risks for the global economy. One risk factor is the situation in China. If the Chinese real estate market continues to deteriorate and the government's measures are unable to revive the economy, this could have a greater impact on Chinese domestic demand over the forecast horizon than assumed. This would also adversely affect the global economy.

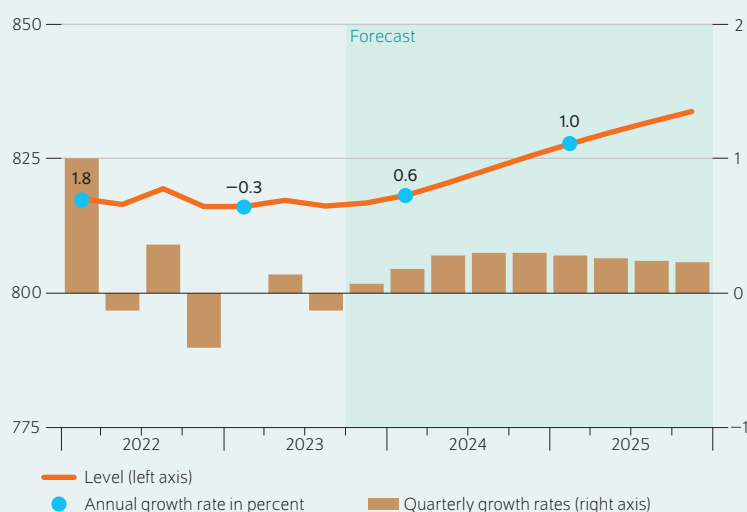
Geopolitical risks have also increased. The war between Israel and Hamas could expand across the region, but relevant actors in the Middle East have indicated they do not want an escalation. However, unforeseen events could cause energy prices to rise. A further geopolitical risk factor is the war in Ukraine, where no end is in sight. An escalation in the trade conflict between China and the United States as well as the severe drought that is currently disrupting vessel traffic in the Panama Canal could weigh on international trade more than expected. Sustained high inflation also poses risks: This would also keep interest rates at a high level for longer, which could call public debt sustainability into question and would argue for a somewhat more restrictive fiscal policy in the future.

German economy trudging through 2023; budget cuts to dampen recovery from 2024 on

Figure 2

Growth of real GDP

In billions of euros (left axis) and quarter-on-quarter in percent (right axis)



Note: Forecast from the fourth quarter of 2023 onwards; price, seasonally, and calendar adjusted.

Sources: Federal Statistical Office; DIW Berlin Economic Outlook Winter 2023.

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The German economy is stagnating during the 2023/2024 winter and will only slowly begin to pick up speed afterward.

The German economy is continuing to tread water, primarily due to lower private household consumption compared to 2022. Economic output declined slightly in the third quarter of 2023 following a minimal increase (Figure 2). Nominal labor income rose sharply over the course of 2023. Until autumn, however, this at best prevented further losses in purchasing power as a result of high inflation. Sluggish investment activity and a cooling foreign trade environment have also slowed the German economy. One ray of hope is that continued strong wage and salary growth coupled with significantly lower price increases will gradually lead to higher real incomes. This compensation for real income losses over the past years is the starting signal for a swift recovery of private consumption and the domestic economy. This catch-up would also be important in light of the cooling global economy and correspondingly subdued foreign demand in the upcoming quarters.

However, the recovery of the German economy has been put on the back burner by the uncertainties regarding German fiscal policy and the cuts announced to the public budgets in the coming years. In November 2023, the German Federal

Constitutional Court ruled that reallocating emergency funds set up during the coronavirus pandemic was unconstitutional. This ruling directly affects 60 billion euros that were reallocated to the *Klima- und Transformationsfonds* (KTF) and indirectly amongst others the Economic Stabilization Fund (*Wirtschaftsstabilisierungsfonds*, WSF) and means that already approved budgets are hanging in the balance, as is the budget draft for 2024. The Federal Government quickly declared a state of emergency for the fiscal year of 2023 so that the debt brake could again be suspended. A concrete proposal for the reorganized 2024 budget was introduced on December 13, 2023, and is expected to be passed in January 2024.

This forecast is based on assumptions that were made before a budget was agreed upon. These assumptions about cuts to public funds correspond to the scale and structure of the cuts agreed upon by the coalition leaders and published on December 13. Specifically, this forecast is based on the assumption that funds from the public budgets will be available in 2023 as planned, but expenditures must be cut as of 2024. It is assumed that public expenditure will be around 19 billion euros lower than originally intended in both 2024 and 2025, 11 billion euros lower in 2026, and three billion euros lower in 2027. The forecast also assumes that funds will be cut primarily from investment measures in the KTF and, to a lesser extent, consumption measures in the KTF and WSF. For example, it is assumed that the EEG surcharge compensation will not be cut. The announced budget cuts due to the Federal Constitutional Court's ruling are likely to lead to major uncertainties, dampening the mood of companies and private households alike, and thus the propensity to invest and consume.

Following 0.1 percent growth in the second quarter, GDP¹ declined by 0.1 percent in the third quarter. Private consumption in particular fell short of expectations: It declined after a slight recovery in the summer, even though disposable incomes increased by a substantial 1.6 percent compared to the previous quarter. Although the effective wages of low-income earners, who often work part time, increased the most, this has hardly equalized labor income overall: The DIW Berlin nowcast on labor income distribution indicates that inequality has recently remained at the 2022 level. Consumption of consumer goods in particular, which comprises the largest share of households' private consumption, is still on the downward trajectory that began in autumn 2022. In the third quarter of 2023, it fell to a level that was last reached in 2012. The ongoing private consumption crisis is likely to be due to the accumulated real income losses of recent years. In addition, it seems that the private households

¹ This forecast uses price-adjusted figures except for when describing price and wage developments, public finances, and public debt.

Table 2

Quarterly data on the development of use and value added components of real GDP in Germany

In percent (quarter-on-quarter, seasonally and calendar adjusted)

	2022				2023				2024				2025			
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV
Private consumption	0.5	-0.3	1.4	-1.1	-0.8	0.2	-0.3	0.2	0.3	0.4	0.4	0.3	0.3	0.3	0.2	0.2
Public consumption expenditure	1.1	0.4	-1.4	-0.1	-1.4	-0.4	0.2	0.2	0.5	0.3	0.2	0.3	0.3	0.3	0.3	0.4
Gross capital formation	2.2	-1.6	1.0	-1.3	1.7	-0.3	0.6	-1.1	-0.7	-0.3	0.2	0.4	0.5	0.7	0.6	0.6
Construction	3.3	-3.9	-0.6	-2.0	2.7	-0.9	0.4	-1.4	-0.6	-0.2	0.2	0.3	0.5	0.6	0.5	0.5
Equipment	1.9	1.6	4.2	-1.5	2.1	0.7	1.1	-1.2	-1.3	-0.8	0.2	0.5	0.6	0.7	0.7	0.6
Other investment	-0.6	0.3	0.1	0.8	-1.6	0.0	0.3	0.3	0.1	0.1	0.2	0.3	0.5	0.7	0.8	0.8
Change in inventories ¹	0.2	0.8	0.2	0.1	-0.6	0.7	-0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic consumption	1.2	0.5	0.8	-0.7	-1.0	0.7	-0.4	0.0	0.1	0.2	0.2	0.4	0.3	0.3	0.3	0.3
Net exports	-0.1	-0.6	-0.4	0.3	1.0	-0.5	0.2	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Exports	-0.1	0.9	1.0	-1.1	-0.2	-0.9	-0.8	-0.1	0.4	0.7	0.9	0.9	0.9	0.9	0.8	0.8
Imports	0.0	2.3	2.1	-1.8	-2.2	0.1	-1.3	-0.3	0.2	0.5	0.9	1.1	1.1	1.1	1.0	1.0
GDP	1.0	-0.1	0.4	-0.4	0.0	0.1	-0.1	0.1	0.2	0.3	0.3	0.3	0.3	0.3	0.2	0.2
Gross value added	0.6	0.3	0.7	-0.6	0.3	-0.2	0.1	0.1	0.2	0.3	0.3	0.3	0.3	0.3	0.2	0.2
Manufacturing	-1.3	0.5	0.7	0.4	-0.1	0.2	-0.9	-0.2	0.2	0.3	0.2	0.2	0.3	0.3	0.3	0.3
Construction	0.7	-2.7	-2.1	-2.4	5.2	-0.7	0.4	-1.3	-0.6	-0.2	0.1	0.2	0.3	0.5	0.4	0.4
Trade, hospitality, transport	-0.3	0.1	1.2	-1.2	-0.4	0.1	1.7	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.4
Professional services providers	1.8	-0.7	0.2	0.2	-0.2	0.4	0.1	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.2
Public services, education, health	1.9	0.7	1.4	-0.5	0.9	-0.7	-0.2	0.3	0.4	0.3	0.3	0.3	0.2	0.2	0.2	0.2

1 Contribution to growth in percentage points.

Note: Forecast from the fourth quarter of 2023 onwards.

Sources: Federal Statistical Office; DIW Berlin Economic Outlook Winter 2023.

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that can afford to continue to wait and save a good portion of their income are doing so; this is suggested by the fact that the savings rate has recently remained high.

Investments have recently been unexpectedly good, primarily due to public investment in public fixed capital formation and commercial construction. Although private fixed capital formation also increased slightly by 0.4 percent, it could hardly compensate for restrained consumption. Together with considerable inventory reductions, domestic use has shrunk by 0.4 percent recently. That the decline in GDP in the autumn was even lower was due to the fact that the imports declined somewhat stronger than the exports, and thus the positive trade balance provided support.

In contrast, production increased slightly in the third quarter, shaped by two different developments: On the one hand, industrial production at minus one percent was clearly in the red. While construction output increased by 0.4 percent, production in the manufacturing sector declined by 0.9 percent, dragging overall output into the negatives. On the other hand, value added in the services sector increased in almost all branches. For example, production in wholesale and retail trade, transport, accommodation and food service activities increased by 1.7 percent. Financial and insurance services also recorded a marked increase at 1.1 percent. Overall, services contributed 0.4 percentage points to value added, compensating for the negative contribution of

industrial production (minus 0.3 percentage points), resulting in a slight overall increase in value added.

Corporate sentiment has brightened since August. The Purchasing Managers' Index remains below the threshold of expansion at 50 index points, but recently increased slightly. Although it remains at a low level, the mood in the manufacturing industry in particular has recovered from its slump in July. The mood in the services sector is also increasingly improving. Since September, the ifo Business Climate Index has been rising again across the board. The economic situation as well as business expectations in the manufacturing sector, as well as industry and the consumer-related services sector are continually being evaluated more positively. Although new orders in the manufacturing sector declined somewhat recently, this was primarily due to a decline in bulk orders; the existing stock of orders is still very large.

Private households, in contrast, are still pessimistic about the future. For example, the *GfK-Konsumklima* declined slightly up until November 2023. However, both the strong growth in disposable income and the recent marked increase in revenue in the services sector paint a much more positive picture for the development of private consumption.

This means that signs for an economic recovery in the coming quarters are a go. For the time being, however, the budget consolidation is likely to slow down the German economy. It is therefore expected to only grow moderately until the end of

Table 3

Key economic indicators for the German economy

	2022	2023	2024	2025
GDP ¹	1.8	-0.3	0.6	1.0
Employed ² (1,000 persons)	45,596	45,950	46,071	46,082
Unemployed (1,000 persons)	2,418	2,608	2,713	2,559
Unemployment rate ³ (Federal Employment Agency concept, in percent)	5.3	5.7	5.9	5.5
Consumer prices ⁴	6.9	5.9	2.4	2.0
Unit labor costs ⁵	3.4	6.3	4.0	2.4
Government budget balance ⁶				
in billions of euros	-96.9	-87.1	-45.0	-27.4
in percent of nominal GDP	-2.5	-2.1	-1.1	-0.6
Current account balance				
in billions of euros	145.1	256.2	299.6	301.9
in percent of nominal GDP	3.7	6.2	7.1	7.0

1 Price adjusted. Year-on-year change in percent.

2 Domestic concept.

3 Unemployed as a percentage of the civilian labor force (definition according to the Federal Employment Agency).

4 Year-on-year change.

5 Compensation of employees per hour worked in Germany as a percentage of real GDP per hour worked.

6 As defined in the national accounts (volkswirtschaftliche Gesamtrechnungen).

Note: Forecast from 2023 onwards.

Sources: Federal Statistical Office; DIW Berlin Economic Outlook Winter 2023.

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the year. In addition to the assumed public expenditure cuts, the increased uncertainty surrounding the debate on future budgetary policy is dampening the economy. Weakening investments will weigh on the manufacturing industry in particular. Moreover, for the time being, positive stimuli from foreign demand are lacking. The only gradual recovery of important trade partners in the euro area, such as France, and the ongoing slump in the Chinese economy will for now probably weigh on German equipment exports in particular. Construction output should increase somewhat due to the large amount of planned and approved construction projects. However, as the number of building applications has been falling sharply for some time, a decline is to be expected from 2024 onward.

The public subsidy cuts and the uncertainty are likely to curb private investment immediately as well as in the coming quarters. While it is assumed that other public funds or another funding source will be used to finance projects that have already been approved, new investment projects, or those that have been planned but have not yet started, will probably be shelved or only partially realized due to less favorable financing conditions and increased uncertainty. Imports will be accordingly weaker, as a majority of investments in Germany are realized through advance services from abroad, apart from construction projects. As exports are developing somewhat more robustly, a positive trade balance should cushion the impact of the investment crisis (Table 2).

Despite the consequences of the ruling and the most recent budget deal, private consumption is likely to recover cautiously. Measures already passed, including those from the

WSF, will still be implemented in 2023. These measures will be canceled in 2024, but they would have been minimal anyway; even without the Federal Court ruling, the energy compensation payments to private households would still have been considerably lower than originally estimated due to the continued decline in energy prices. Further strong nominal wage increases, which should continue into 2024, will support the recovery of private consumption. However, these increases will probably be somewhat lower than recently expected, as the sluggish economy is likely to weigh on employment growth and thus lead to lower wage agreements. Overall, the real income losses suffered by private households over the past years will be increasingly compensated for during the forecast period. As inflation continues to fall and the labor market remains largely robust, the wage development should support purchasing power and increase private households' propensity to consume.

However, after a slight increase at the end of 2023, there is unlikely to be lively recovery over the further course, mainly due to the restrictive fiscal policy. A gradual increase in private consumption will lift the German economy out of its slump in 2024, but growth will be dampened by declining investments until the middle of 2024 and a weak investment development thereafter. Nevertheless investment activity should benefit from the turnaround in interest rates in 2024. In this forecast, it is assumed that the European Central Bank (ECB) will keep interest rates constant until early summer 2024 and then will gradually decrease them. This is in line with the declining inflation rates of the past months: The increase in food prices has recently slowed and energy prices are even decreasing. Moreover, the inflation rate declined much more quickly than expected and is likely to decrease further, although less rapidly than before, as the base effects due to the sharp price increases in 2022 are slowly disappearing. In the final quarter of 2024, inflation is likely to be at two percent again. However, the core rate, which excludes energy and food prices, is likely to fall much more slowly than the overall inflation rate. This is because the rise in wages and the broad-based price pressure outside of energy and food components are likely to be noticeable.

Fiscal policy is likely to be more restrictive than was recently expected. Certain important measures such as the *Inflationsausgleichsgesetz*, from which private households benefit, will continue to support the economic development. However, the Federal Constitutional Court's ruling is expected to require considerable cutbacks and the delayed political reaction is creating uncertainty about specific future funding opportunities. The design of the energy transition is also subject to even greater political uncertainties. This would likely stall companies' and households' propensity to buy. One ray of hope for the coming two years is the anticipated more dynamic development in the euro area, which should boost foreign trade and thus support investment activity and production in Germany.

All in all, price-adjusted GDP will likely decline by 0.3 percent in 2023 due to the weak winter months and following

stagnation. Economic output is expected to grow by 0.6 percent in 2024. In 2025, growth is projected to be 1.0 percent. Thus, DIW Berlin is increasing its 2023 forecast by 0.1 percentage points compared to the fall forecast. This is due to the Federal Statistical Office's revision of the GDP of past quarters. For 2024, the forecast was adjusted downward by 0.6 percentage points. The lower growth rate goes back to both the changing dynamics over the course of 2023 as well as to forecast adjustments as a result of the budget cuts. The budget crisis will lead to a 0.3 percentage point decline in growth in 2024 and a 0.2 percentage point decline in 2025. Above all, private consumption, but investments as well, were revised downward. The output gap in Germany is likely to be minus 1.3 percent on average for 2023 and will barely change in 2024. On average in 2025, it should be minus 0.8 percent.

Average consumer price inflation is likely to be 5.9 percent in 2023 before declining to 2.4 percent in 2024 and to 2.0 percent in 2025 (Table 3). The core rate, which excludes energy and food, is expected to be 5.1 percent on average in 2023 before falling to 2.5 percent in 2024 and to 2.0 percent in 2025.

In addition to risks pertaining to the global economy, the current largest risk to the recovery of the German economy is arguably the unclear situation regarding future public budgets. This is likely to significantly dampen growth prospects, which would weigh on the labor market and reduce wage and salary increases. It would also weigh on investment activity and Germany's weak economic phase would continue on into 2024 due to political uncertainty and the resulting lack of plannability.

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