Germany – Waiting for better times

Due to the erosion of the business environment, our growth forecast for Germany has been lower than that of most economists for quite some time. Nevertheless, the economy is likely to pick up a little in 2025 because the headwinds from monetary policy and the past inflation shock are gradually abating.

Dr. Ralph Solveen

German economy remains weak…

In recent weeks, there has been a series of bad news from the German economy. It shrank slightly in the second quarter, the start of the third quarter was very weak with a 2.4% drop in industrial production, and the renewed decline in sentiment indicators gives little hope that the figures will quickly improve significantly.

… brings structural problems into focus, …

As a result, Germany's economic output in the second half of the year is not expected to be any higher than it was before the pandemic. In view of this stagnation, which has lasted for five years now – if we disregard the temporary slump caused by the coronavirus pandemic – more and more people are becoming convinced that this weak development has structural reasons. In fact, studies show that Germany has become less and less attractive as a business location in recent years compared to other countries.

… which are also unlikely to be overcome quickly

In response to the discussion about Germany's weaknesses as a business location, the German government has launched a "Growth Initiative". Many of its 49 items certainly point in the right direction. However, it is uncertain whether all of them will actually be implemented, and from today's perspective it is difficult to say whether they will noticeably boost growth. Moreover, experience shows that such structural measures take effect only with a significant lag. So there is much to suggest that these measures will not provide much of a boost to the economy, at least not this year and for much of next year.

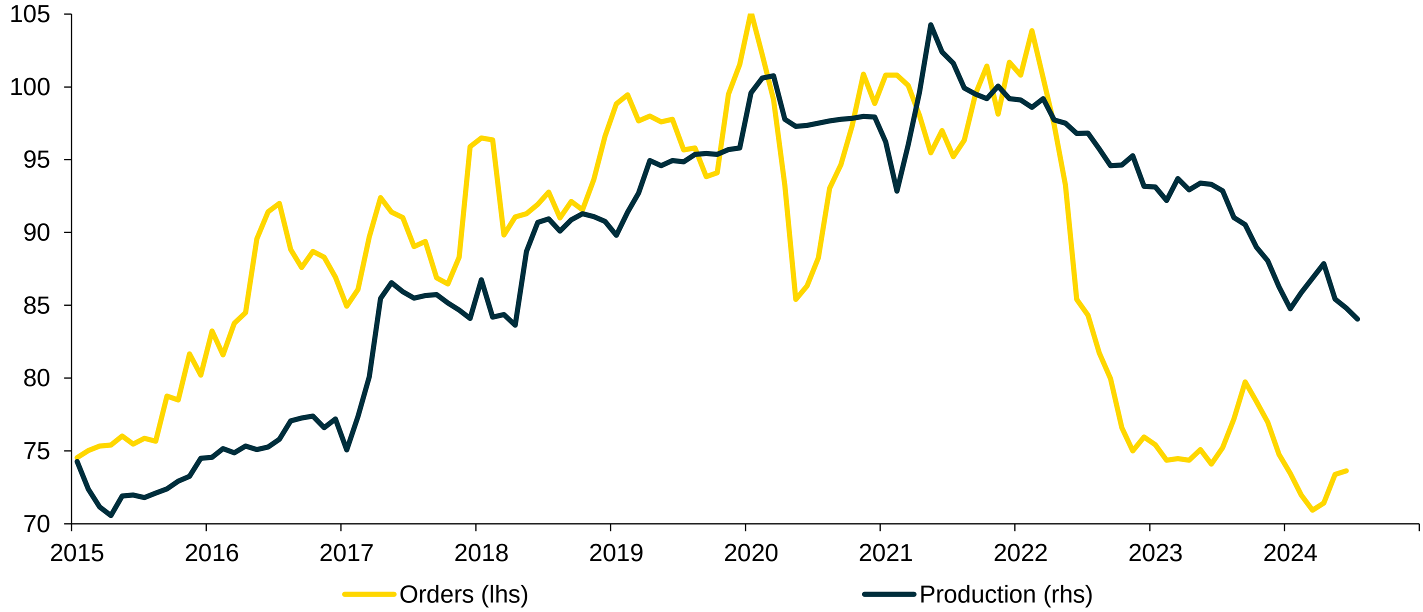
However, the burden of monetary policy is easing…

However, the long-lasting weakness of the German economy cannot be attributed to these structural factors alone, but also to other adverse factors. The first of these is monetary policy, which was tightened massively in 2022 and 2023, not only in the eurozone but also in all other western industrialized countries. A **study by the ECB** shows that the effect of monetary policy on the more capital-intensive manufacturing sector is significantly greater than on services, so that the German economy, given the rather high share of manufacturing in its value added, is likely to have suffered more from the interest rate hikes than most other economies in the euro area. Furthermore, German manufacturing is particularly strong in the capital goods sector, where demand at home and abroad has been hit especially hard by the less favorable financing conditions.

However, the headwind from monetary policy should gradually ease now. This is because the vast majority of interest rate hikes were implemented more than a year ago, so the economy is likely to have increasingly adjusted to the higher interest rate level. However, a rapid turnaround is hardly to be expected. For example, sentiment indicators have recently fallen again. Furthermore, in the construction sector – or, more precisely, in the building construction segment – production has not yet been fully adjusted to the significantly lower level of incoming orders (Chart 1). In the coming year, however, the burden of higher interest rates is likely to ease, especially since the key interest rate cuts will gradually start to have a positive effect on the economy from the middle of the year.

Chart 1 - Building construction has not yet made up for the slump in orders

New orders and production in building construction, seasonally adjusted monthly figures, average of the past three months, 2015=100



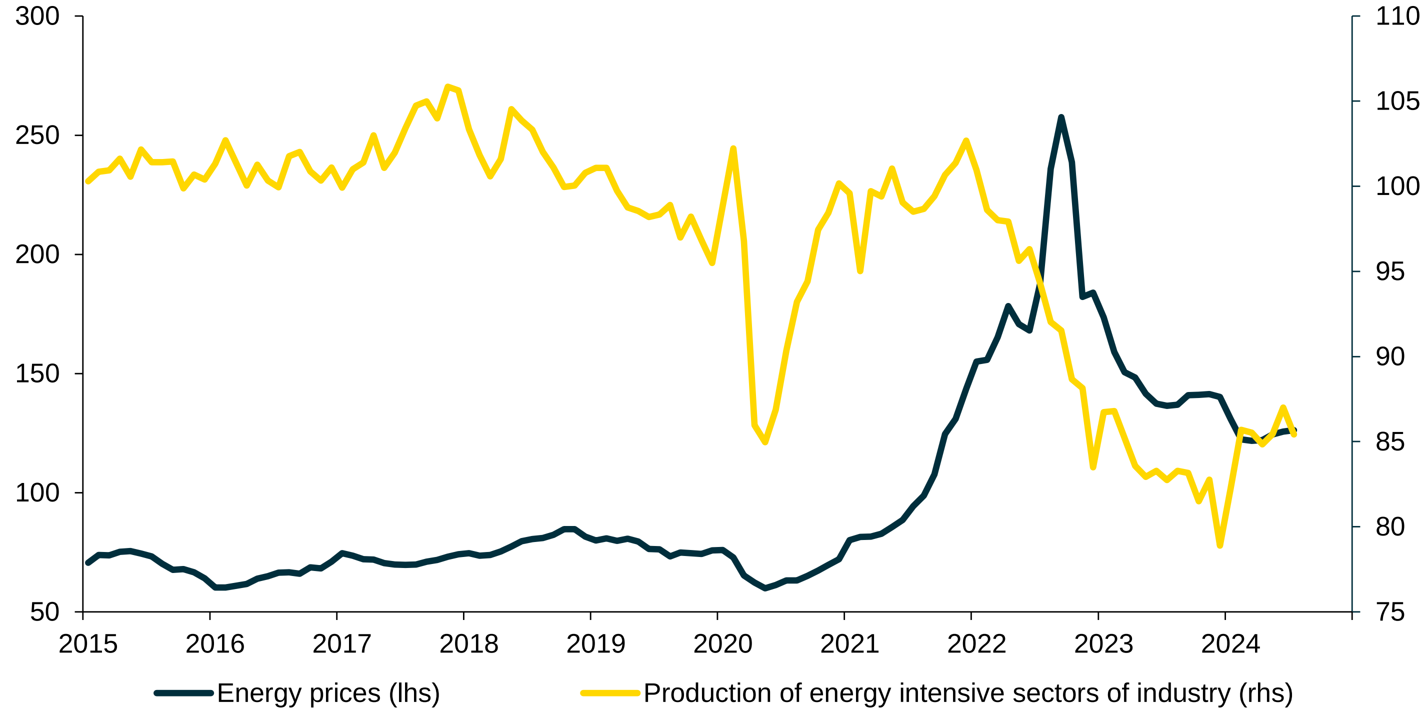
Source: Destatis, S&P Global, Commerzbank Research

... as well as the burden caused by higher energy prices

With energy prices, another burden on the economy is likely to lose importance. Their explosive rise in 2021 and 2022 has undoubtedly contributed significantly to the fact that production in energy-intensive sectors of manufacturing has recently been significantly lower than in the summer of 2022 (Chart 2). Despite the decline in the past two years, energy costs are still significantly higher than before the pandemic, which has certainly reduced the attractiveness of Germany as a business location, especially compared to the US and China, and is likely to lead to a relocation of production capacities in the long term. For the short-term development – i.e. for the rest of this year and next year – it is more important that the decline in energy costs has made the manufacture of some products profitable again in Germany, which is why production in these sectors has recently increased somewhat.

Chart 2 - Energy prices much lower, but still high

Energy prices: Average of producer prices for lignite, natural gas, heating oil and electricity weighted by the share of energy consumption in industry in 2021; production of energy-intensive industrial sectors; monthly figures and 2015=100 in each case



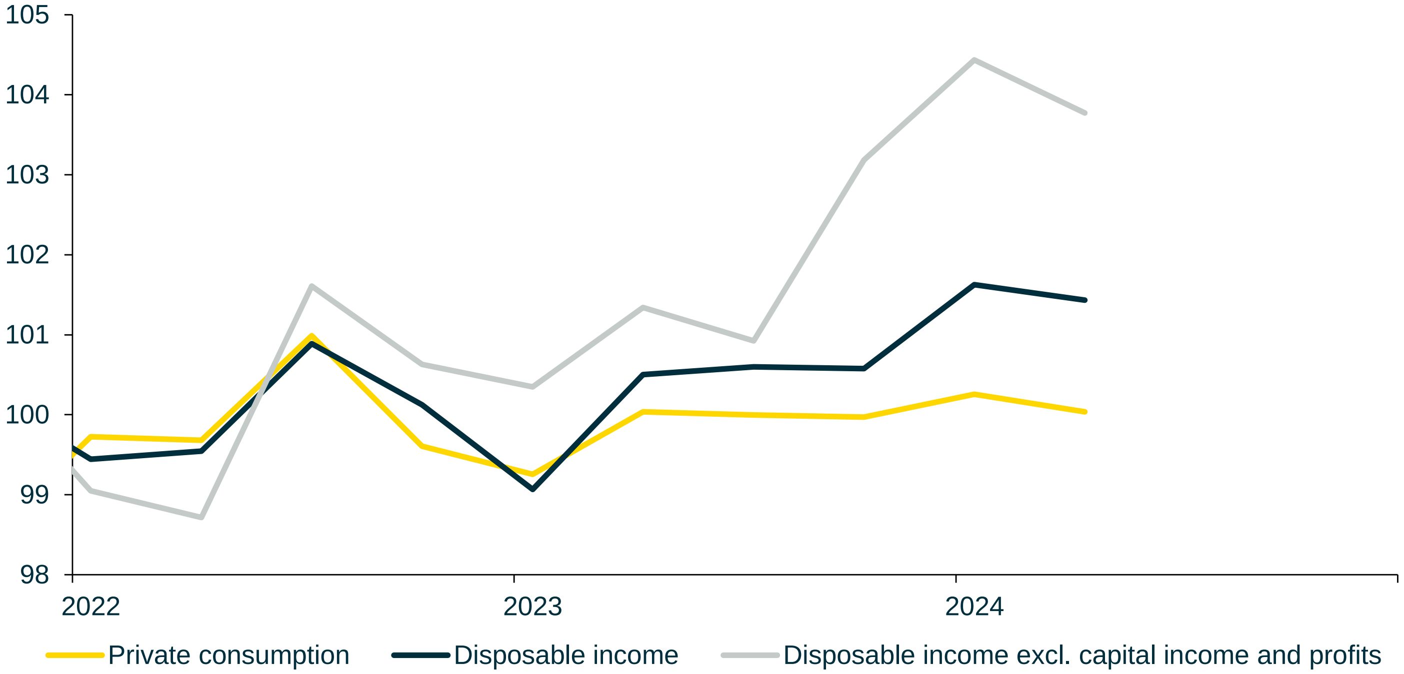
Source: destatis, Commerzbank Research

Waiting for the consumer

Private household consumption has repeatedly been disappointing in recent quarters. In real terms, it has stagnated over the past two and a half years, although the disposable income of all private households has grown faster than prices since 2022, resulting in a real income increase of 1½% (Chart 3). Disposable income excluding capital income and profits – which is probably more important for the development of private consumption – is in real terms almost 4% higher than on average in 2022.

Chart 3 - Upward potential for private consumption

Real, each deflated using the private consumption deflator, 2022=100

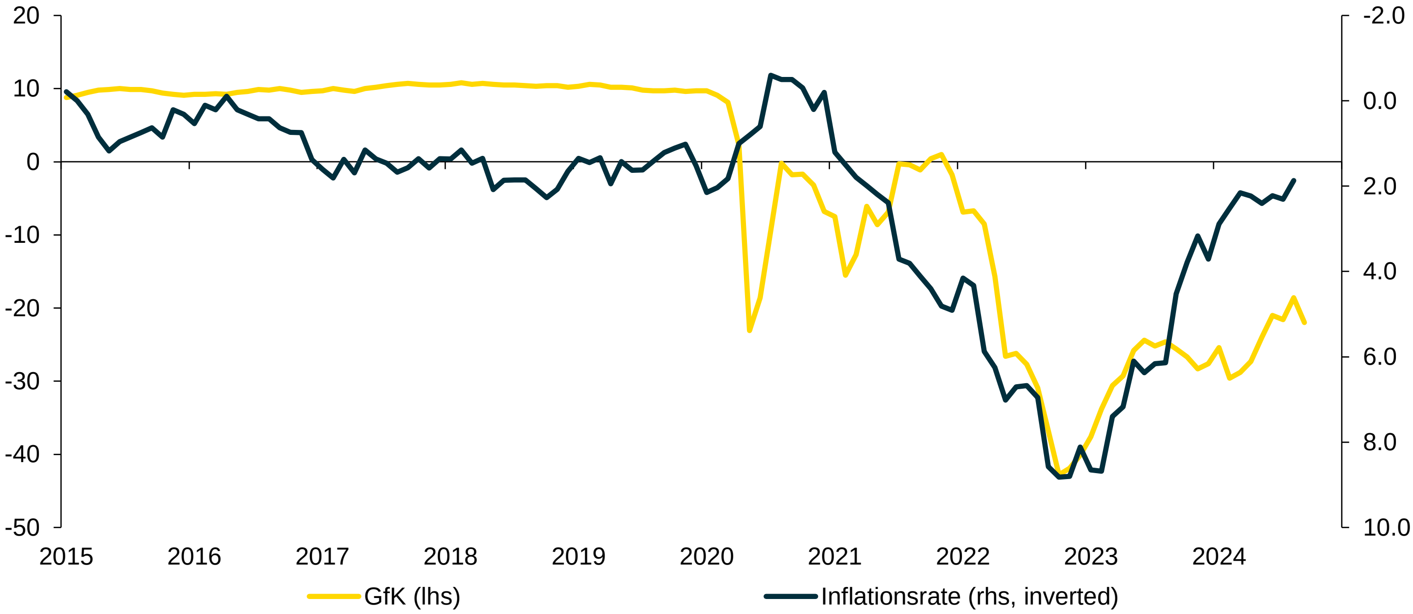


Source: Destatis, S&P Global, Commerzbank-Research

In the long term, higher real incomes will boost consumption. However, private households do not yet appear to have overcome the shock of the past two years, when the massive rise in inflation caused their real incomes to fall significantly at times. The consumer climate, for example, is still far from having recovered from the slump it suffered in the wake of the massive price increases, even though the rate of inflation has fallen back to its earlier levels (Chart 4).

Chart 4 - Consumers obviously still shocked by jump in prices

Germany, GfK consumer climate, seasonally adjusted monthly figures; consumer price index, year-on-year percentage change



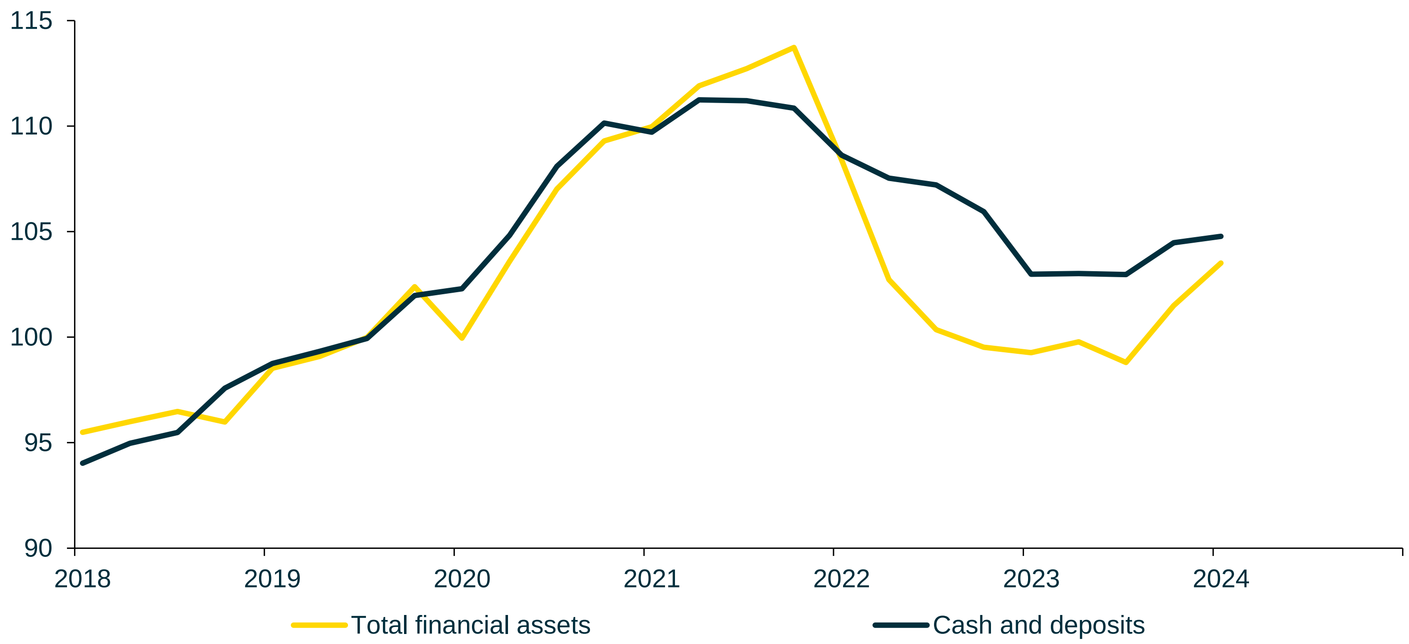
Source: Destatis, GfK, S&P Global, Commerzbank-Research

One explanation for this could be that the total real income of all households is now higher than before the pandemic because employment has increased. In contrast, this is not true for individual households on average. In fact, real compensation per hour worked in the second quarter was actually slightly lower than before the outbreak of the pandemic. What's more, the losses in households' real financial assets have not yet been offset. The purchasing power of the cash and bank deposits held by private households was almost 6% lower than in mid-2021, while total financial assets show a similar decline (Chart 5).

It is difficult to estimate how long the spending restraint of private households will last. However, there are no signs of a rapid turnaround, meaning that positive impetus for the economy from this side is also unlikely to materialize until next year.

Chart 5 - Private households have become poorer

Private households, real, deflated using the private consumption deflator, quarterly figures, index 2019=100



Source: Bundesbank, Destatis, S&P Global, Commerzbank Research

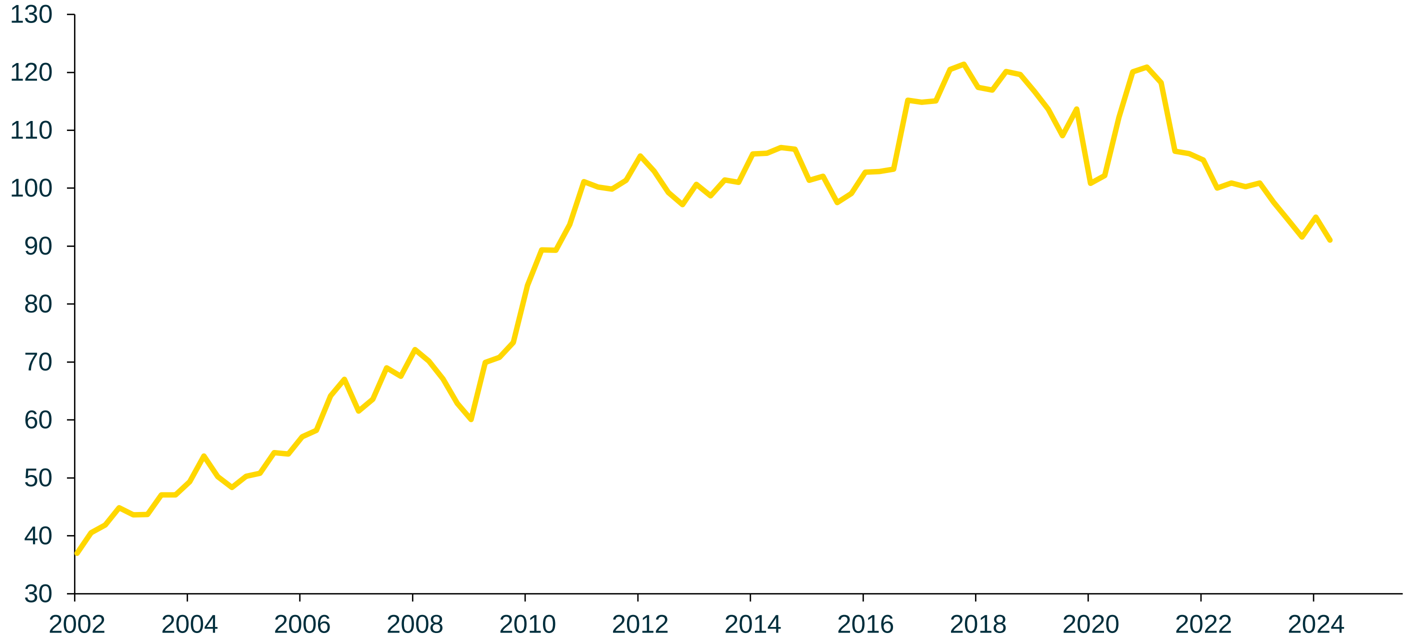
One negative factor remains: China

Another negative factor is likely to remain in place: the weakening trade with China. For a long time, strong demand from China for German products and the strong position of German companies in the Chinese market were an important growth driver for the German economy, which contributed significantly to the fact that it grew much faster than the eurozone average for several years. In recent years, trend in eurozone exports – deflated and seasonally adjusted data are available only for this region – have been pointing downwards (Chart 6). In addition to weak domestic demand in China, this is probably due to the fact that German companies are producing more locally and that Chinese policymakers are pushing for becoming more independent of foreign suppliers by promoting domestic producers of investment goods (see also **here**).

None of these factors is likely to change significantly for the time being. Rather, in view of the overcapacity that exists in many areas in China, competition from Chinese suppliers is likely to intensify in many markets, thereby placing a particular burden on industry.

Chart 6 - Eurozone exports to China fall

Eurozone exports of goods to China and Hong Kong, volume, seasonally adjusted quarterly data, index 2015=100



Source: Eurostat, Commerzbank Research

Bottom line: Good chance of recovery, but not until next year...

In view of the easing of the burden imposed by monetary policy and energy prices, the chances are good that the economy will pick up a little in the coming quarters despite the problems in China and the structural problems of the German economy. However, it is difficult to say when this will be the case. This is because both the length of the time lag for monetary policy and the duration of the inflation shock for private households are very uncertain. However, the recent weakening of sentiment indicators and the fact that the correction in the construction industry is obviously not yet over suggest that this recovery is not to be expected before next year.

... and growth will be modest

At the same time, there are a number of factors that argue against a strong upturn. Rather, we can only expect a very modest recovery. In addition to the structural problems of the German economy, monetary policy is likely to be relaxed only slowly, so that the headwind from this side will ease, but – unlike in previous cycles – no strong tailwind is to be expected. Added to this are the problems with China. We therefore expect the economy to grow only slightly by 0.5% on average in the coming year, after it is likely to stagnate this year.

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In accordance with ESMA MAR requirements this report was completed 20/9/2024 07:15 CEST and disseminated 20/9/2024 07:15 CEST.

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