Germany: Another year of stagnation and political turbulence

Farmers' protests, train strikes and disappointing macro data; the first weeks of the new year did not wash away a disappointing 2023, in which the economy contracted by 0.3% year-on-year. In fact, it looks like the German economy has entered another challenging year of stagnation and political turbulence

The German Chancellor, Olaf Scholz, is feeling the heat

2023 was another turbulent one, with the German economy in permanent crisis mode. In fact, since 2020, there has been a long list of crises and challenges it's had to face: supply chain frictions resulting from the pandemic and war in Ukraine, an energy crisis, surging inflation, and a tightening of monetary policy, China's changing role from being a flourishing export destination to being a rival that needs fewer German products, and several structural shortcomings. A combination of geopolitical risk events, cyclical headwinds, and home-grown deficiencies.

The hard economic reality does not look pretty

In light of so many challenges, some take comfort in the fact that the economy is "only" stuck in stagnation and has avoided a more severe recession. And, indeed, things could have been worse. But this should be no reason for any complacency. On the contrary, even if the worst of the weakening in sentiment seems to be behind us, the hard economic reality does not look pretty.

Looking ahead, at least to the first few months of 2024, many of the recent drags on growth will still be around and will, in some cases, have an even stronger impact than last year Just think of the still-unfolding impact of the European Central Bank's monetary policy tightening, the potential slowing of the US economy, new uncertainty stemming from recent fiscal woes or fresh supply chain frictions as a result of military conflict in the Suez Canal. A recent illustration of the longer-term impact of energy prices, higher interest rates and changing economic structures is the gradual increase in insolvencies since mid-2022.

On a more positive note, what could lift economic sentiment and GDP are positive real wage growth, a rebound in Asia and, further down the road, some rate cuts from the European Central Bank. Also, a turn in the inventory cycle could bring some relief in early 2024, although this turn has not yet happened and would probably only be short-lived.

All in all, we expect the current state of stagnation and shallow recession to continue. In fact, the risk that 2024 will be another year of recession is high. We expect the German economy to shrink by 0.3% YoY this year. It would be the first time since the early 2000s that Germany has gone through a two-year recession, even though it could prove to be a shallow one.

The 'sick man of Europe' debate

It was the big summer theme in Europe, and Germany is still debating it: weak growth, worsening sentiment and pessimistic forecasts have brought back headlines and public discussion about whether Germany is once again the 'sick man of Europe'. The Economist reintroduced the argument this summer, more than two decades after its ground-breaking front page. The infamous headline seems currently justified when looking at the state of the German economy and the fact that the former stronghold of Europe has become a growth laggard.

Germany's international competitiveness had already deteriorated before the Covid-19 pandemic and the war in Ukraine. These events have only exposed structural weaknesses like the lack of investment in energy transition, digitalisation, infrastructure and education. These are weaknesses that are the flipside of fiscal austerity and wrong policy preferences over the last decade.

> *What Germany needs is a full menu card of policy measures*

What Germany needs is a full menu card of policy measures. These measures could be categorised into those boosting confidence and giving companies security and clarity, as well as supply-side improvement measures. In the first category, think of an energy price cap for industry, not for one winter but for several years. Such a measure should be accompanied by a clear schedule for the energy transition. This would prevent more companies from exiting the country and producing elsewhere. Combined with fast depreciation rules of investments in digitalisation and renewable energies, this could safeguard the economy's industrial backbone. With subsidies for sectors such as artificial intelligence, batteries or hydropower, the government could support innovation.

Finally, less bureaucracy, more investment into e-government, and consequently faster public tenders and the implementation of federal investments at the regional level would strengthen the supply side of the economy. It is a long list that can easily be extended and broadened. One thing, however, is clear: any overhaul of the economy will be almost impossible as long as fiscal austerity remains the dominant tune.

The German Constitutional Court's ruling at the end of 2023, however, has brought austerity back to the political centre stage. There is some wiggle room in the constitutional debt brake, but generally speaking, there is no political majority in favour of going all in with a large deficit-funded fiscal stimulus or reform programme. That means structural changes will rather have to come from the corporate world.

European and three state elections likely to add to policy uncertainty

The combination of four years of economic stagnation, a long list of structural transitions and policy uncertainty has led to protests, strikes and the falling popularity of the current government. In Germany, governments hardly ever collapse or abdicate. However, with European elections along with three state elections in the East, there is a high chance that the right-wing AfD will further increase its support, adding to political uncertainty and complicated decision-making. Over the last two decades, Germany has been the symbol of both economic and political stability in Europe. It will require some effort to keep this picture intact.

The German economy in a nutshell

	2022	2023F	2024F	2025F
GDP	1.9	-0.3	-0.1	1.3
Private consumption	4.4	-1.1	-0.5	0.2
Investment	0.6	0.7	1.6	3.0
Government consumption	1.2	-2.0	1.9	2,0
Net trade contribution	-0.5	0.5	-0.5	0.5
Headline CPI	8.7	6.1	3.0	2.0
Unemployment rate (%))	3.2	3.2	3.5	3.3
Budget balance as % of GDP	-2.5	-2.0	-1.5	-1.3
Government debt as % of GDP	66	67	61	60

Source: Thomson Reuters, all forecasts ING estimates

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