Germany: Rising like a phoenix

From recession candidate to growth champion. Once the economy ends its period of hibernation, it could become Europe's growth champion over the next two years

Olaf Scholz was elected German Chancellor in December

The German economy went into hibernation at the turn of the year. New restrictions to tackle the fourth wave of the pandemic and the Omicron wave, as well as higher energy prices, dented private consumption and sent the economy into contraction in the fourth quarter. As a result of that weak fourth quarter, the likelihood of Germany being in an outright recession at the turn of the year has increased. High energy prices will continue to weigh on private consumption, even if social restrictions are lifted in the course of February. Also, even with some temporary relief from exports and industrial activity, the Omicron wave in Asia and the Chinese New Year clearly argue against a steep short-term improvement in supply chains. Maybe the German economy gets away with just one black eye and there won't be a part two to the winter contraction story, but in any case, the short-term outlook doesn’t look too good.

Rising like a Phoenix

Even if the economy were to fall into a technical recession, the downturn would be mild and short-lived and is unlikely to harm the labour market. Indeed, we stick to our view that the German economy will stage an impressive comeback in the spring. Why? Order books are richly-filled and new orders are still coming in, while inventories have been reduced to record lows. It is therefore only a matter of time, with a few more container and microchip shipments from Asia to Europe, before industrial production surges again.

Admittedly, geopolitical risks and high energy prices as a damper on both production and consumption could still spoil the growth party but the end of social restrictions and significant relief in global supply chains should combine to give the German economy an enormous boost.

We expect the German economy to finally return to its pre-crisis level at the end of 1Q 2022. This is much later than justified by one of the largest fiscal stimulus packages worldwide. Global supply chain frictions have simply delayed the positive impact from the crisis measures. However, delayed does not mean repealed, and the stimulus can still feed through to the economy. What's more, the new government has agreed on a significant fiscal stimulus package to kick-start investment into the green transition while also announcing an increase in the minimum wage of almost 30% in October this year. The government plans to front-load many of these stimulus measures, which should lead to another high fiscal deficit but at the same time, should support the economic recovery.

Structural challenges will re-emerge

As the economy leaves the pandemic behind, the structural challenges of the past will re-emerge. The new government is clearly trying to tackle the problem of too little investment and too few structural reforms, improving German competitiveness over the coming years. However, the government does not seem to attach too much priority to making the pension and health care systems more sustainable. The structural problem currently most pressing for the short-term outlook is labour shortages. Companies are desperately seeking employees as both recruitment plans and the lack of labour as a limiting factor to production are both at record highs. In fact, the labour shortage was already an issue in 2018 and 2019 but before wages could rise, the pandemic came. The drivers behind these labour shortages are the following: lack of EU labour mobility, demographics and skill mismatches. Interestingly, for the first time in years, there is currently a positive correlation between labour shortages and wage developments, suggesting that wage growth will accelerate. Eventually, higher wages will not be enough to tackle labour shortages. The government will have to think about automation, immigration and training.

All in all, we expect the German economy to quickly exit its period of hibernation by the spring. If we are right, the headlines accompanying the German economy this year could go from one extreme to the other: from recession to growth champion. And all of this in less than one year.

The German economy in a nutshell (%YoY)

	2020	2021F	2022F	2023F
GDP	-4.9	2.8	3.5	4.1
Private consumption	-6.1	0.2	4.2	2.8
Investment	-4.0	1.7	4.0	5.3
Government consumption	3.3	3.1	3.5	2.1
Net trade contribution	-2.1	0.3	-0.1	0.5
Headline CPI	0.4	3.1	3.9	2.0
Unemployment rate (%))	3.1	3.4	3.1	3.0
Budget balance as % of GDP	-4.2	-4.5	-6.5	-2.5
Government debt as % of GDP	72.0	72.0	74.0	68.0

Source: ING

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