German economy sees its first two-year contraction since early 2000s

The German economy ended the year 2024 with another disappointment. The economy shrank by 0.1% quarter-on-quarter, marking the second consecutive year of contraction since the early 2000s

Never change a good tradition. As at the start of every year, the German statistical office just released an early estimate of last year's economic performance, without having any hard data for the month of December. According to this estimate, the German economy shrank by 0.2% year-on-year in 2024, from -0.3% YoY in 2023. Adjusted for working days, the German economy shrank by 0.2% YoY in 2024 and 0.1% YoY in 2023. It's the first time since the early 2000s that the German economy contracted for two years in a row. And, yes, the early 2000s were the last time Germany received the very flattering title of "sick man of Europe". History doesn't repeat but it rhymes.

Economy contracted by 0.1% QoQ at end of last year

Next to the headline number, the second most important information stemming from this annual exercise of releasing GDP data only two weeks after year ended is that it provides a very tentative first estimate of fourth quarter GDP growth. According to the statistical agency, the German economy shrank by 0.1% quarter-on-quarter in the final quarter of the year. Don't forget that this estimate is calculated without any hard data for December. Given reports on industrial companies pausing production in December due to surging energy prices, the risk of a downward revision of fourth quarter GDP data is real.

2024 was the year when cyclical and structural headwinds became a storm

Looking at the broader picture, the German industry has been the best example of the entire economy's problems over the last few years: stuck between cyclical and structural headwinds, and finally realising that the old macro business model of cheap energy and easily accessible large export markets is no longer working. 10 years of underinvesting, deteriorating competitiveness and China's shift from export destination to fierce industrial competitor have taken – and will continue to take – their toll on the German economy. Contrary to the early 2000s when Germany's economic "sickness" or problem was high unemployment and a rigid labour market, the current problems are much more diverse and hence even more difficult to solve than they were 20 years ago. Let's also not forget that the external environment in the early 2000s was much more supportive for Germany, with China entering the World Trade Organisation and the EU's enlargement as opposed to the current environment of geopolitical tensions, a war in the backyard and the rise of protectionism.

For now, Germany's problems seem mainly concentrated in industry, particularly in automotive. Five years after the onset of the Covid-19 pandemic, German industrial production remains about 10% below its pre-pandemic levels. Manufacturing capacity utilisation is at lows comparable only to those seen during the financial crisis and the initial lockdowns. This paints a rather unflattering picture of a nation known as an industrial powerhouse. However, given the importance of industry for the entire economy, spillovers to other sectors – be it via sentiment or real economic channels – are already happening.

What will 2025 bring?

Looking ahead, besides some rather technical rebounds, a substantial recovery of German industry is not in sight just yet. Inventories have continued to increase instead of turning around, and have now been at elevated levels for more than a year. At the same time, order books also have not started to recover and the important turning of the inventory cycle has still not started.

Add to this looming tariffs and the expected modern version of 'beggar-thy-neighbour' policies by the incoming new US administration, and the outlook for German industry remains anything but rosy. Not just because of the potential impact on German exports, but more so the effect on German investments if companies were to move production to the US.

At the same time, the increase in bankruptcies since mid-2023 is likely to enhance the already gradual turning of the labour market, potentially denting hopes for a private consumption rebound.

Needless to say that the upcoming elections will be key for Germany's economic outlook in 2025 and beyond. Even if the risk of too much complacency even after two years of stagnation remains, hope is that any new German government would decide on a longer-term plan for economic reforms and investments. Just to make up for the investment gap accumulated over the last decade, Germany would need additional investments of 1.5% GDP per year over the next 10 years. This is not all public investments, but the government will have to play an important role in providing public goods like infrastructure and education and creating incentives for private investments. This is why in our base case scenario, we see some kind of reforms combined with infrastructure investments after the elections. If we are right, this should bring at least a small boost to confidence and growth from the second half of the year onwards.

At the same time, however, it is also becoming increasingly clear that even in a best-case scenario with reforms and investments, any new government will not try to overhaul the old economic business model, but rather try to rejuvenate the old one. Less red tape, some tax cuts to stimulate spending and investments, possibly attempts to lower energy costs and infrastructure investment – all of which feature in any European economist's wish list, and a growth booster for the economy.

Whether these measures will really be sufficient in competing against China and the US is a completely different question. What Germany would get after the elections is a refurbished model of its economy – clearly better than the old one with cracks, battery failures and very few gadgets, but also not a shiny, sprinkling new model that makes the competition speechless.

Author

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de