

# German economy avoided contraction in 2Q

With stagnating GDP growth, the economy avoided a contraction in the second quarter but only just. The best part of today's data release is the upward revision of first quarter growth. As high energy and commodity prices continue undermining purchasing power and profit margins, a technical recession in the second half looks like a done deal



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## Better than feared

The just released flash estimate of 2Q German GDP shows that the economy stagnated, from a significantly upwardly revised 0.8% quarter-on-quarter in the first quarter. On the year, the economy grew by 1.5%. GDP components will only be released at the end of August but according to available monthly data up to May and the statistical agency's press release, public and private consumption supported economic activity, while construction and trade were a drag.

Supportive factors for the economy such as post-lockdown reopenings and filled order books have been losing momentum rapidly. Weaker global demand, supply chain frictions, and high inflation denting consumption are hitting the German economy. In fact, consumer confidence is already in clear recession territory and it looks as if the rest of the economy is quickly following suit. The

economy avoided contraction but the only positive element of today's data is probably the upward revision of first quarter growth.

## Escalating energy crisis remains single largest risk to an already downbeat outlook

Needless to say that currently, there are more downside than upside risks to the outlook. The single largest risk is further disruption to Germany's energy consumption and a complete stop in the Russian gas supply. The reopening of the NordStream1 pipeline last week has already helped to fill up Germany's gas reserves, which currently stand at around 67%. To get through the winter without any Russian gas, the government intended to have reserves filled up to 95% by 1 November. This target increasingly looks unachievable and explains why energy supply is the number one topic in German media and politics. Earlier this week, four economic research institutes released a short study showing that Germany could get through the winter without gas supply disruptions if NordStream1 keeps on delivering at the current 20% capacity level. A further escalation in the energy crisis will remain a key risk for the economy going into the winter. In this regard, we are also cautious in sounding overly optimistic about the current lower gas consumption levels (12% year-on-year) as lower gas consumption and an economy in stagnation reminds us of the chicken and the egg.

## Heading into a perfect storm

In the base case scenario with continuing supply chain frictions, uncertainty and high energy and commodity prices as a result of the ongoing war in Ukraine, the German economy will be pushed into a technical recession. To make matters worse, the current dry weather has reduced water levels in the main rivers close to their 2018 levels, when low water levels led to the disruption of supply chains. All of this makes for a perfect storm in the second half of the year.

The perfect storm in the coming quarters will overlap with a need for structural changes. In fact, we have often written about the need for more investment and structural change. The war in Ukraine is the mother of all reasons for this. Actually, the war in Ukraine puts an end to the German economic business model as we knew it - a model which was mainly based on cheap energy imports and industrial exports into an increasingly globalised world. Of course, everything is possible, but it does not really look as if this world will return any time soon. Instead, Germany needs to reduce its energy dependence and step up the green transition. It also needs to adjust to a world of friendshoring, in which services will increasingly take over from industrial exports. The need to scale up investment in education, infrastructure and digitalisation adds to a long list of changes needed at the current economic turning point, or 'Zeitenwende'. In this regard, the finance minister's announcement to return to balanced budgets next year is as surprising as it is unrealistic, and in our view, rather driven by political motives than by economic foresight.

Germany's track record with structural change is not overly successful, at least not with swift structural reforms. Think of reunification or the labour market reforms of the early 2000s. In the early phases, structural reform almost always comes at an economic cost. The same holds for the current 'Zeitenwende'. Real disposable incomes of households will suffer, and companies will have increasing difficulty in dealing with the costs of higher energy and commodity prices, putting corporate profit margins under pressure. A loss of economic wealth looks like a logical consequence. However, the upside of structural change is that eventually, Germany will manage to deal with these issues and challenges. At the current juncture, this offers a scarce silver

lining. For German industry and the entire economy, the green transition and the need for investment are both a challenge and an opportunity.

## Structural change and European solidarity - well known topics but upside down

Germany will need time and money to manage its economic 'Zeitenwende'. In the short run, the economy is facing a perfect storm. The economy avoided a contraction in the second quarter but looking into the remainder of the year, a recession looks almost unavoidable. In the longer run, the economy can only return as Europe's powerhouse if it implements investment and structural change as determined and committed as it demanded from other eurozone countries in the past.

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