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The German economy is in a 'slowcession' and needs a new reform agenda

Another drop in Germany's most prominent leading indicator, the Ifo index, confirms that the economy is back on a downward trend before any upward trend had actually started. The case for a new reform agenda 2030 is getting stronger



The rebound that never was.

Remember at the start of the year, some observers took a more optimistic stance on the German economy? Supported by the mild winter weather, the reopening of the Chinese economy and the misconception that having avoided the worst automatically leads to a decent upswing, the mood in Germany brightened. Half a year later, the reality is presenting an inconvenient truth: the economy is stuck in the twilight zone between stagnation and recession – a so-called 'slowcession' – and is in urgent need of a new reform agenda.

Third consecutive monthly drop in Ifo index

The just-released latest Ifo index confirms the picture of a 'slowcession'. After a six-month expansion at the start of the year, Germany's most prominent leading indicator has now dropped

for the third consecutive month, coming in at 87.5 in July, from 88.5 in June. The weaker-than-hoped-for Chinese reopening, a looming US recession and ongoing monetary policy tightening seem to be weighing on German company sentiment. The growing feeling that Germany is in for a longer period of subdued growth also seems to have reached German business. Both the current assessment and the expectations component fell. Expectations are now as low as at the end of last year, while the current assessment component is as low as in late 2020.

Stuck in the twilight zone between stagnation and recession

The optimism at the start of the year seems to have given way to more of a sense of reality. A drop in purchasing power, thinned-out industrial order books, as well as the impact of the most aggressive monetary policy tightening in decades, and the expected slowdown of the US economy, all argue in favour of weak economic activity. On top of these cyclical factors, the ongoing war in Ukraine, demographic changes, and the current energy transition will structurally weigh on the German economy in the coming years. However, all is not bleak. The stuttering Chinese rebound could easily bring some temporary positive surprises as well. Also, the drop in headline inflation and the actual fall in energy and food prices combined with higher wages should support private consumption in the second half of the year.

Next week, we will get a first estimate of GDP growth in the second quarter. A third straight quarter of contraction can no longer be excluded. The second half of the year looks no better. Confidence indicators have worsened and hard data are going nowhere. We continue to expect the German economy to remain at a de facto standstill and to slightly shrink this year before staging a meagre growth rebound in 2024.

The case for a 'reform agenda 2030'

Leaving aside the short-term outlook, the current economic situation in Germany looks eerily familiar to that of 20 years ago. Back then, the country was going through the five stages of grief, or, in an economic context, the five stages of change: denial, anger, bargaining, depression and acceptance. From being called 'The sick man of the euro' by *The Economist* in 1999 and early 2000s (which created an outcry of denial and anger) to endless discussions and TV debates (which revelled in melancholy and self-pity) to an eventual plan for structural reform in 2003 known as the 'Agenda 2010', introduced by then Chancellor Gerhard Schröder. It took several years before international media outlets were actually applauding the new German Wirtschaftswunder in the 2010s.

Germany's international competitiveness had already deteriorated before the pandemic but this deterioration has clearly gained further momentum in recent years. Supply chain frictions, the war in Ukraine and the energy crisis have exposed the structural weaknesses of Germany's economic business model, and come on top of already weak digitalisation, crumbling infrastructure and demographic changes. These structural challenges are not new but will continue to shape the country's economic outlook, which is already looking troubled in the near term. Judging from the current public and political debate in Germany, the denial stage is over and the country is somewhere between bargaining and depression. However, as illustrated by the discussion on a return to fiscal austerity next year, there doesn't seem to be a full sense of urgency, yet.

In the early 2000s, the trigger for Germany to move into the final stage of change management, 'acceptance' (and solutions), was record-high unemployment. The structural reforms implemented back then were, therefore, mainly aimed at the labour market. At the current juncture, it is hard to

see this single trigger point. In fact, a protracted period of de facto stagnation without a severe recession may reduce the sense of urgency among decision-makers and suggests Germany could be stuck in the stages of denial, anger, bargaining and possibly depression for a long time. However, the current mix of policy uncertainty, weak electorate support for the government coalition in polls and the rise of the Alternative for Germany (AfD) political party in recent polls suggests that the time for a positive reform agenda 2030 has come.

Author

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

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