German economy makes headlines again for all the wrong reasons

The German economy contracted at the end of 2024, and there's a high likelihood this downturn will lead to a winter recession

Now it’s official. The German economy ended 2024 in contraction, shrinking by -0.2% quarter-on-quarter. On the year, the economy also contracted by 0.2%. Fun fact: this was the third year in a row that the German economy ended the year with a negative quarter.

GDP details will only be released next month but available monthly data as well as the statistical office’s press release suggest that exports dragged the economy into contraction. At the same time, today’s data confirms that 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 consecutive years.

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

Looking at the broader picture, the German economy has now been stuck between cyclical and structural headwinds for several years, and 2024 was finally the year that many politicians realised that the old macro business model of cheap energy and easily accessible large export markets was no longer working.

Ten years of underinvesting, deteriorating competitiveness and China's shift from an export destination to a 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 far more favourable for Germany, with China's entry into the World Trade Organization and the EU's enlargement. This contrasts sharply with today's geopolitical tensions, a nearby war, 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.

Near term outlook doesn't promise any substantial change

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 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 of a private consumption rebound.

Election campaign shifts focus from economy to immigration

Needless to say, the upcoming elections will be key for Germany's economic outlook in 2025 and beyond. While the election campaign had started with almost all focus on the economy, the latest developments have turned the campaign away from the economy to immigration and how to deal with the right-wing AfD. Yesterday, the German parliament voted for a plan by CDU leader Friedrich Merz for tougher migration measures; with votes from the AfD and against the votes of the current minority government parties, SPD and Greens. This vote won't have any impact on actual measures, for now, but has unleashed a heated debate in Germany on whether or not the CDU broke the informal agreement of Germany's mainstream parties not to cooperate with the far right. The counterargument used by the CDU is that there hasn't been any cooperation but that it would simply do what it thinks is right, no matter whether the 'wrong' parties would support it.

No matter where anyone stands in this debate, the shift from economics to immigration, the strong polling of the AfD, as well as the discussion on how to deal with the AfD, will give the next three weeks new momentum. Together with the hardening of the red lines between centre-left and centre-right political parties, this is likely to make coalition negotiations after the elections even more complicated. There is an increasing risk that the shift of the election debate towards immigration will eventually lead to a muddling-through stance on economic reforms and investments.

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