Latest Ifo index adds to Germany's economic woes

Another sharp drop in Germany's most prominent leading indicator suggests that the economy is in for a longer period of stagnation than previously expected

After a six-month expansion at the start of the year, Germany's most prominent leading indicator – which indicates firms' projections for the next six months – has now dropped for the fourth consecutive month, coming in at 85.7 in August, from 87.3 in July, and is now back down at levels last seen in autumn last year.

The ongoing weakness in the Chinese economy, ongoing monetary policy tightening, and policy uncertainty regarding the energy transition and energy prices 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.

The 'Sick man of Europe' debate

The optimism at the start of the year seems to have given way to more of a sense of reality. In fact, the last few weeks have seen an increasingly heated debate about Germany's structural weaknesses under the placative label "sick man of Europe".

Indeed, the current economic situation and the public debate in Germany look 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.

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.

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 deficiencies are homemade as they are the flipside of fiscal austerity and wrong policy preferences over the last decade.

On a more positive note, the labour market is definitely not a problem at the moment. Plus, 20 years ago Germany breached the European fiscal rules, while it currently has one of the most solid public finances of all eurozone countries.

German economy to remain in stagnation

Today's data pours more cold water on those hoping that the country's economic weakness will be short-lived. In fact, the latest round of sentiment indicators suggests that the stagnation in the second quarter was not the end of contraction but rather a temporary respite. The German economy is in for a longer period of stagnation. The new debate about the 'sick of man Europe' could finally increase the sense of urgency among decisionmakers; more than a protracted period of de facto stagnation could.

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