German Ifo improved in May

Germany's most prominent leading indicator increased for the second month in a row but its absolute level, as well as low expectations, argue against too much optimism

The gradual return of optimism continues but only if the focus is limited to the very short run. Germany's most prominent leading indicator, the Ifo index, just increased for the second month in a row to 93.0 in May, from 91.9 in April. The increase was mainly driven by an improved current assessment. The expectations component remained almost unchanged and close to levels last seen at the start of the pandemic. This good Ifo reading seems to reflect filled order books and post-lockdown improvements but we remain cautious. Weak expectations show that German businesses are not blind to high uncertainty, supply chain frictions and strong inflation.

Economy is facing a series of structural changes

Today's Ifo index seems to reflect new optimism. However, it also tells a tale of two economies: one with filled order books and post-lockdown reopenings and one which will also be hit by the economic consequences of the war in Ukraine and new supply chain frictions. In fact, supply chains are still disrupted due to the Shanghai lockdown and the war in Ukraine. Some might be disrupted for good. Elevated uncertainty and fear will weigh on both supply and demand in the coming months. Real disposable incomes of households will suffer, and companies will have increasing difficulties dealing with the costs of higher energy and commodity prices, putting corporate profit margins under pressure.

The German economy will definitely not plunge as it did during the 2020 lockdowns. However, with the pending risk of stagflation and the longer-term impact of the war in Ukraine, and structural changes in the economy, we warn against too much optimism. Just because things won't get worse does not automatically mean they will get better.

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