

December Ifo index sets Friedrich Merz's Christmas tree on fire

With the Ifo index dropping to the lowest level since May, the German economy remains stuck in stagnation at the end of another disappointing year. Yet, despite the gloom, signs of a cyclical rebound are beginning to emerge



German Chancellor Friedrich Merz has a lot of work to do to get Germany out of its economic rut

For the German economy, the year has ended as it started: with a disappointing Ifo index reading.

Germany's leading indicator came in at 87.6 in December, from 88.1 in November. This is the lowest level since May this year. Admittedly, despite today's drop, the absolute level is still higher than at the start of the year (when it was 85.1).

While the current assessment component remained unchanged at 85.6, expectations weakened to 89.7, also the lowest level since May.

Thanks for nothing

The German economy has been on an emotional roller-coaster ride this year, swinging from optimism to pessimism, culminating in policymakers finally acknowledging – after years of denial – that the era of good times is truly over.

After the U-turn on fiscal stimulus and the new government coalition agreement, optimism returned to Germany, only to enter a new phase of national depression in the second half of the year due to doubts about creative budget accounting and a clear lack of structural reforms. Since the end of 2022, there have been only two quarters in which the economy actually grew.

Still, this dreadful economic performance has at least one upside: at the end of the year, everyone seems to have finally understood that Germany's economic problems are not just a fatal concatenation of unfortunate circumstances but rather the result of years of underinvestment, a lack of structural reforms and the rise of China from export destination to system rival. US tariffs and the stronger euro exchange have only aggravated the problems, but are not the root cause.

The new government's decision to ramp up infrastructure and defence investments is only the start. To some extent, these investments, together with the recently announced subsidies for industrial energy prices, are a bare minimum to restore competitiveness. More is needed. Whether it is the well-known reduction of red tape, the introduction of e-government, mastering and lowering the financial burden of demographics or tax cuts, the "to-do" list for German Chancellor Friedrich Merz and his government is probably longer than an average child's Christmas wish list.

Tentative signs of a cyclical rebound in the making

While it won't be easy to solve the structural challenges – definitely not quickly – there are at least tentative signs of a bottoming out and some cyclical improvement in the next year. Industrial orders have now increased for two months in a row, inventories have come down somewhat, and capacity utilisation has started to turn. Admittedly, all of these signs are still very tentative and weak.

Add to this the announced reduction of energy prices for industry, and at least a cyclical rebound in industrial activity should be in the making. Last but not least, the German parliament only signed off on the 2026 budget a few weeks ago and will approve almost 30 defence contracts amounting to some €50bn this week. The impact of fiscal stimulus will come; it only takes a while.

German economy should leave stagnation behind in 2026

All in all, following the principle of 'prepare for the worst and hope for the best', today's Ifo index reading doesn't come as a surprise. To the contrary, it fits into our base case scenario that the German economy will end the year with yet another growthless quarter. However, there is sufficient evidence to suggest that the German economy will leave stagnation behind next year, even though any cyclical rebound should definitely not be mistaken for a structural improvement.

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