German Ifo surges in February, but Russia-Ukraine conflict not taken into account

The German Ifo index has surged to its highest level since August last year. While such a strong reading would normally spread optimism, last night's Russia-Ukraine developments have probably made this prominent leading indicator rather backward-looking

Germany's most prominent leading indicator, the Ifo index, increased for the second month in a row, not only on improving expectations but also on a much better current assessment. In February, the Ifo index came in at 98.9, from 96.0 in January. This was the sharpest increase since March 2021, bringing the headline number to its highest level since August last year. Both the current assessment and the expectations component improved significantly.

Forward-looking indicator is once again rather backward-looking

With last night's developments in the Russia-Ukraine conflict, it seems as if the times in which forward-looking indicators are actually backward-looking indicators will never end. Today's Ifo index paints a picture of Germany's economic prospects without any escalation of the Russia-Ukraine conflict. In this world, there are the first signs of relief in supply chains and optimism on the back of a much milder economic impact of Omicron than previously feared. With order books filled to the rim, industrial activity should flourish in the coming months, supporting our view of a sharp rebound of the German economy in the course of this year.

In the world painted by today's Ifo index and also by yesterday's Purchasing Managers' Index (PMIs), inflation remains the largest risk for the German economy as it could undermine the rebound both from the supply and the demand side. Record high price expectations and record high producer price inflation suggest that the pass-through from higher energy and commodity prices to consumers is still in full swing. As a result, inflationary pressure will hardly abate in the coming months and could possibly even worsen. At the same time, higher production costs cannot endlessly be passed through to consumers or intermediates. At some point, higher production costs will also have to be absorbed by profit margins, decreasing the odds for wage increases and investments.

This, alongside the current developments in the Russia-Ukraine conflict, means uncertainty has increased significantly, and today's Ifo index is not leading but rather backward-looking. We don't want to speculate about the next steps in the Russia-Ukraine crisis, but it is clear that the new uncertainty will weigh on business sentiment, dent purchasing power if energy prices continue to increase, and could eventually also, temporarily, subdue business investment. Yesterday, the New York Times quoted Jason Furman, a former economic adviser to US President Barack Obama, saying "Russia is incredibly unimportant in the global economy except for oil and gas...It's basically a big gas station." We leave this quote uncommented and only think of Germany's dependence on Russian energy.

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