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German Ifo index improves for third consecutive month in July

At face value, the increase in the Ifo index is promising news for the German economy. However, in these highly volatile geopolitical times, even leading indicators have become backwards-looking rather than forward-looking indicators

Germany's most prominent leading indicator, the Ifo index, increased to 86.6 in July, from 85.6 in June. While the current assessment component dropped somewhat (86.5, from 87.0 in June), expectations improved significantly, to 86.7, from 84.1 in June.

Normally, three consecutive increases in the Ifo index points would be a reason to party, celebrating increasing optimism in German businesses and higher hopes for an economic rebound in the second half of the year. However, in this highly volatile geopolitical environment, even leading indicators have become rather outdated.

Today's Ifo index reading probably reflects more the initial relief after the US-Iran Memorandum of Understanding than the recent surge in energy prices.

Resilience doesn't automatically mean economic rebound

Not only business sentiment, but the broader German and European economy has been on something of an emotional rollercoaster in recent months.

The cause, of course, has been geopolitical tensions and volatile energy markets. Just weeks ago, optimism was building following the announcement of a Memorandum of Understanding between the US and Iran, which helped push oil prices lower and fuel hopes of a long-awaited economic rebound.

Instead of returning optimism, however, the global economy is now facing the fallout from a return to dangerously high energy prices, despite some relief in oil markets over the last few hours.

Needless to say, the short-term outlook for the German economy is highly dependent on energy prices and the war in the Middle East. Even if the German economy has proven to be more resilient than some had feared, an expansion of the conflict to other trading routes would obviously pose a new risk to the economic rebound. Also, the warm and dry summer weather has brought water levels in main transportation waterways to record low levels, potentially affecting industrial supply chains and activity in the construction sector.

As concerning as the latest developments are for the short-term outlook, the longer-term outlook for the German economy will still be driven by fiscal stimulus and the investments in defence and infrastructure, as well as the ability to translate recent reform plans into real and tangible action. In this delicate mix of short-term downside risks and longer-term optimism, let’s not forget that to fundamentally bring the German economy back on a sustainable growth path, the economy still needs more reforms that improve international competitiveness, a clear plan for affordable energy and more direct incentives, e.g. tax cuts, to boost domestic demand, ie both corporate investments and private consumption. Elements that are currently still missing in the recently announced reform package.

All in all, even if the third consecutive increase in the Ifo index is not yet a reason to prepare for the next growth party in Germany, it at least shows a certain resilience of the economy. However, let’s not forget that the absolute level of the Ifo index is still below its five-year-average, illustrating how slow and cumbersome the path out of stagnation still is.

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