German Ifo index takes a nose dive in March

Soaring energy prices and new uncertainty have dented business optimism. For now, the war in the Middle East should only delay, not derail, Germany's rebound but the risks have clearly shifted to the downside once again

Germany's most prominent leading indicator fell to 86.4 in March from 88.4 in February

Germany's long-awaited cyclical upswing took a hit in March, as the war in the Middle East has blasted away optimism. This is at least what the just released Ifo index is telling us. Coming from the highest level since last summer, Germany's most prominent leading indicator took a severe hit as the war in the Middle East, soaring energy prices, and new uncertainty dented previous optimism. The headline reading came in at 86.4, from 88.4 in February. While the current assessment component remained unchanged, expectations took the worst hit since the Russian invasion in Ukraine, dropping to 86.0, from 90.2 in February.

Soaring energy prices are clear risk to outlook but fiscal stimulus story still holds (for now)

The war in the Middle East has changed a lot but not everything. The surge in energy prices could dampen any industrial rebound, even if German corporates appear relatively shielded from oil price risks for now. The effects would nonetheless leave broader marks, at least in the short term.

A first inflation wave is already in the making, from higher gasoline prices to knock-on effects on transportation and food. And longer-term implications on supply chains can no longer be excluded. Gas reserves are currently at their lowest level at this time of the year in five years, which could bring a cost-push for corporates and households next winter. Let's not forget that the so-called energy-intensive industries account for some 17% of industrial gross value added and employ just under one million people in Germany. Still, this is not (yet) 2022, when surging energy prices – amplified by fiscal stimulus during the pandemic – first fuelled an inflation wave and then a wage-price spiral.

That said, it would be premature to drift into outright pessimism. Let's not forget that the fundamental drivers of Germany's economic rebound this year are still there: fiscal stimulus of more than €200bn for defence and infrastructure this year alone remains a strong argument against premature doom-mongering.

Economy still in need of reform

The first three months of the year, with geopolitical tensions, new tariff uncertainty and now soaring energy prices, are another painful reminder that Germany needs to start doing some serious multitasking. The country must develop a credible long term plan to structurally strengthen the economy, while at the same time managing successive crises.

Doing the latter without the former simply wastes time. And in this respect, the latest developments in Berlin are hardly encouraging. Hopes that the window for reform would finally open after the recent regional elections – and remain open until the next round in the autumn – have already been dashed. According to news reports, the government is now aiming to agree and implement reforms between Easter and the summer.

What kind of reforms? Healthcare and pensions are on top of the priority list, as rising costs linked to an ageing population demand urgent action. But there should be more. Germany is still missing a long-term, consistent strategy for affordable energy. Reform of the tax system could also boost growth. And the agreed reforms on deregulation, cutting bureaucracy, accelerating digitalisation and reforming the federal system still await implementation. An impressive long to-do list and a small window of opportunity, which hasn't even started and seems to be shrinking by the day.

For now, the war in the Middle East is a risk for Germany's cyclical rebound but not (yet) enough to completely derail it, rather delay it.

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