

## German industry holds up, but not enough to stop a recession

A small increase in industrial production in May is too little to take away our recession fears for the German economy



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Industrial production just wrapped up an entire batch of weak May macro data in Germany. Output increased by 0.2% month-on-month in May, from an upwardly revised +1.3% MoM in April. On the year, industrial production was down 1.4%. Compared with the first quarter, however, industrial production is still down. Weak activity in the construction sector could be another drag on the entire economy. We continue to expect a contraction of the German economy in the second quarter.

### Solid confidence indicators but too weak hard data

At face value, absolute levels of most leading indicators suggest that the German economy should have grown in the second quarter. However, supportive factors for the economy such as post-lockdown reopenings and filled order books have been losing momentum rapidly. Weaker global demand, supply chain frictions, and high inflation denting consumption are hitting the German economy. In fact, consumer confidence is already in clear recession territory and it looks as if the rest of the economy is quickly following suit.

This week's macro data have increased the risk that the economy has already dropped into recessionary territory in the second quarter. Order books have continued to shrink, retail sales remained weak, the trade balance showed a monthly deficit for the first time since 1991, and now, despite today's small increase, industrial production remains too weak to be a growth driver.

## Question is not if but how long the economy will be in recessionary territory

Looking ahead, even if the current holiday mood wants to make us believe that all is well, the outlook for the German economy is anything but rosy. Currently, in the base case scenario with continuing supply chain frictions, uncertainty and high or higher energy and commodity prices as a result of the ongoing war in Ukraine, the German economy will be pushed into a technical recession. 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. A scarce silver lining – not only for the German industry but for the entire economy – is the green transition and the need for investment. Actually, these investments are urgently needed as the three pillars of Germany's successful economic business model – exports, industry and energy – have become Germany's Achilles' heel.

Needless to say that currently there are more downside than upside risks to the outlook. The single largest risk is further disruptions to Germany's energy consumption and a complete stop in the Russian gas supply. Currently, Germany's gas reserves are filled by less than 60%. To get through the winter without any Russian gas, the government intended to have reserves filled up to 90%. A target that increasingly looks unachievable. It will not take until the winter before the energy crisis will escalate further. The government's decisions to bail out an energy company and to change the so-called pricing adjustment mechanism, which allows firms to pass on costs to the consumer, as well as the fact that NordStream 1 will be – temporarily – offline as of next Monday, are just a few illustrations of what could become a perfect storm. It's probably time to dig out all these different estimates of the economic impact a full ban on Russian gas and oil could have on the economy.

All in all, this week's macro data were yet another disappointment for the German economy. The main question is no longer whether the economy could contract this year but rather for how long it will be in recessionary territory.

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