

Strong industrial production paints picture of how German rebound could have looked

Industrial production surged in January. The economy was on the right track for the expected strong rebound in the course of the year. The war in Ukraine has changed everything



The (economic) world that could have been. Economic data in January underlined the German economy's solid start to the New Year, confirming the view of a strong rebound in the course of the year on the back of fading Covid restrictions and improving supply chains. Needless to say, the war in Ukraine has changed everything.

Industrial production in January came in at 2.7% month-on-month, from a significantly upward revised 1.1% in December. On the year, industrial production was up by 1.8%. Despite the increase, industrial production is still some 3% below its pre-pandemic level. The improvement in industrial production was driven by all sectors. Activity in the construction sector surged by more than 10%, benefiting from the mild weather in January. Even without any further improvement, industrial production would be more than 3% above its level in the fourth quarter.

German economy is facing stagflation

More generally speaking, the German economy had a solid start to the year. In addition to today's industrial production data, retail sales were up strongly, industrial orders surprised to the upside and only exports disappointed. Everything pointed to our own base case scenario of an economy that will strongly gain momentum in the course of the year. The end of Covid restrictions, improving supply chains and filled order books were the ingredients for such a rebound; only inflation was a threat. The last two weeks have changed this economic scenario dramatically.

Instead of a strong rebound, the German economy is facing a very uncertain future and the risk of outright stagflation is increasing by the day. Germany's dependence on Russian oil and gas is common knowledge by now. The sheer impact from higher prices and the increases since the start of the year should shave one percentage point off GDP growth this year. And this is without any supply disruptions. Given that gas reserves in Germany are currently filled by some 30% and oil reserves at any time have to cover the import volume of 90 days, Germany could get through the summer in case of an import ban on Russian gas and oil but not longer than this. Higher energy prices are no longer only a threat to private consumption but increasingly also to industry. Higher costs and possible supply disruptions will weigh on industrial production. Also, supply chains, particularly for the automotive industry will be impacted by the war in Ukraine; very likely for good. Just when the supply chain frictions of the last two years were about to improve, German industry is about to tumble into its next problem. Add to this high uncertainty for companies and households and the economic prospect for Germany become bleak. Silver linings for the longer term are the announced fiscal stimulus packages, increasing defence spending and once again, stepping up the energy transition.

The last two weeks have changed the world and have also changed the prospects for the German economy dramatically. Instead of strong momentum in the course of the year, the economy is now facing stagflation, driven by high dependence on Russian oil and gas, new supply chain frictions and high uncertainty for businesses and households. Quite different from the economic world that could have been.

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