ZEW index adds to bad macro news out of Germany

August's ZEW reading only adds to the bad news out of Germany. The long list of risks and challenges the German economy is facing makes a recession in the second half of the year almost inevitable

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It’s not the most reliable leading indicator but the most timely one. Germany’s ZEW index fell to -53.3 in August, from 53.8 in July. The ZEW index is now close to its all-time low seen during the financial crisis. The current assessment also weakened to -47.6, from -45.8 in July, the lowest level since April 2021. The reasons for yet another disappointing data release out of Germany are clear: the almost never-ending long series of risks and challenges for the German economy has become even longer in recent weeks, with two recent additions: low water levels and a gas levy.

Of all the leading indicators, the ZEW index is the least reliable one. It reflects financial analysts’ views, which obviously do not always reflect business or consumer confidence. What the ZEW index has signalled better than other indicators in the past, however, are turning points. With this in mind, today’s ZEW reading does simply not bode well.

More generally speaking, the German economy is quickly approaching a perfect storm. The war in Ukraine has probably marked the end of Germany’s very successful economic business model: importing cheap (Russian) energy and input goods, while exporting high-quality products to the world, benefitting from globalisation. The country is now in the middle of a complete overhaul, accelerating the green transition, restructuring supply chains, and preparing for a less globalised world. And these things come on top of well-known long-standing issues, such as a lack of digitalisation, ageing infrastructure, and an ageing society, to mention a few. In the coming weeks and months, these longer-term changes will be overshadowed by shorter-term problems: high inflation, possible energy supply disruptions, and ongoing supply chain frictions. In recent days, these shorter-term problems have become larger as low water levels and the new gas levy have added to inflation and recession concerns.

Low water levels

Like many parts of Europe, Germany has been hit by a long, unprecedented drought. Water levels have been dropping continuously over the summer and last week, the water level on the Rhine River fell under the critical 40cm mark. Barges can no longer be loaded at full capacity but at a maximum of one-third and some routes will be cancelled. But there's more: industry facilities at the shores of the Rhine will increasingly have problems using water for cooling.

Back in 2018, low water levels shaved off some 0.3 percentage points of German GDP growth over two quarters. However, back then, the low water period only came in late September. This time around, low water levels have come earlier and there is little rain relief in sight. To make things worse, waterways are essential for coal transportation, which in turn is needed to offset less gas from Russia. This means that unless the weather brings any substantial relief, the low water levels will do more economic harm than in 2018. We expect the low water levels to shave off at least 0.5 percentage points of GDP growth in the second half of the year.

Gas levy

Yesterday, the German government announced a gas levy for households and businesses, which will come into effect in October. This surcharge was set at 2.4 euro cents per kilowatt hour. Current gas prices are around 17 euro cents. This levy is meant to cover the additional costs incurred by gas providers, as higher wholesale gas prices couldn't be passed through to consumers, yet it is still unclear whether this surcharge includes or excludes VAT.

Almost half of German households are heated using gas and gas remains an important energy source for industry. According to government estimates, the levy will lead to an additional cost of around 500 euros per year for a four-person household. However, don't forget that next winter, energy providers will be able to pass through higher energy prices to consumers as they can adjust prices once a year. The government announced that it is looking into compensation measures for lower-income households, possibly an increase in child benefits, income tax reductions or direct financial support. Such measures could smooth the negative impact of the levy on growth but not on inflation. With this new gas levy, we now expect headline inflation to reach double-digit levels in the final quarter of the year.

Recession is almost certain

An economic recession in Germany was already our base-case scenario at the start of the summer, due to high energy and commodity prices, ongoing supply chain frictions, and the war in Ukraine. The fact that the entire German economic business model is currently up for renovation will also weigh on the economy's growth prospects in the coming years. With the new levy and the impact of low water levels, inflation rates at double-digit levels almost look like a done deal for the final quarter of the year and it would need an economic miracle to avoid a recession in the second half of the year.

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