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Germany: Small setback by politics

German Ifo index drops in December, suggesting businesses surprisingly do seem to care about politics

Germany's most prominent leading indicator, the Ifo index, ended the year with a small setback. In December, the Ifo index dropped to 117.2, from 117.6 in November. This is still one of the highest readings ever.

The components, however, show an interesting split in German business sentiment. While the current assessment component continued to increase and now stands only slightly below its all-time-high from July, the expectation component took a severe hit, decreasing to 109.5, from 111.0 in November. The sharpest drop in the expectation component since January 2017 suggests that German businesses do seem to care about politics.

Remarkable and impressive year for German economy

Today's Ifo index was the last important economic data coming out of Germany this year. Only December inflation data to be released on 29 December could get markets' and ECB watchers' attention. The Ifo index marks the end of a remarkable year for the German economy. A year ago, consensus forecasts for German growth were around 1.5% for 2017. Now, GDP growth is likely to come in at around 2.5%. How could the German (and the Eurozone) economy surprise so positively?

Today's Ifo index is the first gauge of business sentiment since the collapse of the coalition talks

A year ago, the German recovery looked already rather stretched. Sentiment indicators stagnated, with Brexit, the upcoming Dutch and French elections political risks had increased, and the new US administration had added possible trade wars into the growth equation of every forecaster. One year later the lesson is clear: "it was not politics, but economics, stupid". Following a real Trump-spirit, the strong labour market, low-interest rates, low inflation and a weak euro made already great private consumption, investments and net exports even greater.

More of the same in 2018?

Looking ahead, the same fundamentals which have supported growth in 2016 and 2017 should still be in place in 2018. The only question is how much additional stimulus low-interest rates, a relatively weak euro, strong domestic momentum and the recent upswing of the entire Eurozone economy can still provide to the mature cycle of the German economy.

In our view, still a lot. The German economy still has some upward potential as the output gap is positive but not extraordinary high, capacity utilisation is above historical average but still lower than in 2007 and investments have only started to increase this year.

At the same time, the current political impasse in Berlin should hardly have any impact on growth as previous experiences in the Netherlands and Belgium nicely illustrated. Only the fiscal stimulus, which we had previously expected, will now clearly be delayed; though not aborted.

After two years of outperformance and exceeding expectations, it will be hard for the German economy to beat its own expectations in 2018. But strong fundamentals and the accelerating growth momentum in the entire Eurozone suggest that it is not impossible and that the German economy is all set for another strong year. However, some uncertainty remains or to say it with the words of our favourite forecaster, Yogi Berra, "The future ain't what it used to be".

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