New growth concerns for Germany after latest IFO numbers

The latest IFO figures end a six-month rally of surging optimism. It's yet another illustration that confidence seen at the start of the year has been replaced by new growth worries

Shoppers in Hamburg

In May, Germany's most prominent leading indicator, the Ifo index, dropped for the first time after a six-month expansion, coming in at 91.7 from 93.6 in April. Recent banking turmoil finally seems to have caught up with German companies' assessments. The slight stumbling of the Chinese reopening, monetary policy tightening and a looming US recession seem to be weighing on German companies' sentiment. While the current assessment component only dropped marginally, expectations plunged more significantly.

Growing divergence between sectors, but also hard and soft data

Before we read too much into today's Ifo index, we must remember that, since last summer, there has been a disconnect between hard and soft data. Despite the sharp drop in confidence indicators at the end of last year, the German economy actually grew in the third quarter, and even the small contraction in the fourth should have been much stronger judging from soft indicators.

Looking ahead, the question is whether the recent improvement in leading indicators will really translate into positive hard data or whether we will first see a reversal of last year's disconnect, i.e. improving soft data but disappointing hard data.

In the same vein, yesterday's PMIs, despite another increase, should be taken with a pinch of salt. What is striking, however, is the strong divergence within the German economy. While the manufacturing component weakened further, the services sector component improved. This growing separation looks unsustainable and something will have to shift. We fear that it will be services, which will increasingly suffer under weak manufacturing activity and weak disposable incomes.

Generally speaking, the optimism at the start of the year seems to have given way to more of a sense of reality. A drop in purchasing power, thinned-out industrial order books, as well as the impact of the most aggressive monetary policy tightening in decades, and the expected slowdown of the US economy all argue in favour of weak economic activity. On top of these cyclical factors, the ongoing war in Ukraine, demographic changes, and the current energy transition will structurally weigh on the German economy in the coming years.

The first drop in the Ifo index after a six-month rally is further confirmation of fading optimism and new growth concerns. We are not saying that the German economy will be stuck in recession for the next couple of years, but with several short and long-term challenges, growth will remain subdued at best.

Author

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de