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GERMANY

German economy defies surging oil prices and interest rates

It's almost too good to be true. The fifth consecutive increase in the Ifo index suggests that the German economy has staged a cyclical rebound. Of course, this is not the same as a structural recovery – but it's a start



There are still downside risks to Germany's short-term outlook, but the strong first half of the year alone has prepared the economy for its best growth performance since 2022

Almost secretly, the German economy has developed unexpected resilience, with its leading indicator, the Ifo index, now up for the fifth consecutive month. In September, the Ifo index stood at 89.9, up from 88.8 in August, and is now at its highest level in more than a year. And you actually start wondering, "why?"

To make things even better, both the current assessment and the expectations component improved significantly. Surging energy prices and interest rates? Supply chain disruptions due to low water levels in Europe and the closure of the Strait of Hormuz? It seems German sentiment has become immune, or numb, to the long list of potential downside risks. But why is it that this measure has been improving for five months in a row? The honest answer would probably be that we simply don't know. The more analytical answer is that fiscal stimulus is finally reaching the real economy and that economic activity has become more self-sustained than often feared.

On track for the best growth performance since 2022

The German economy may have weathered the first half of the year better than expected, but past performance is no guarantee of future success. To some extent, the resilience in the second quarter was also driven by the fact that other regions were hit harder by the closure of the Strait of Hormuz, making some German companies a kind of crisis beneficiary. The German government's tax rebate on fuel also prevented private consumption from falling off a cliff, a factor that will have played no role in the third quarter but is returning as of 1 October.

Looking ahead, there are clear risks posed to the German outlook: the war in the Middle East, which it seems could be slowly turning into a forever war, oil prices remaining at elevated levels, as well as the likely upcoming shock of higher gas prices in the next heating season and renewed trade tensions. And there's more. Even if rain over the last few days in Germany has brought limited relief, the low water in the main transportation waterways is another threat to industrial supply chains and production. At the same time, though, order books have started to recover in recent months, pointing to some positive momentum in industry. And the billions of euros from the government's fiscal stimulus on defence and infrastructure have started to trickle down into the economy.

While there are still clear downside risks to the short-term outlook, the strong first half of the year alone has prepared the economy for its best growth performance since 2022. We currently expect GDP growth of around 1% this year.

Political uncertainty remains

The biggest unknown for the German outlook, particularly the longer-term outlook, remains whether the government is still willing and able to implement the already announced structural reforms. And to go beyond that. So far, the announced reforms – as disruptive as they might feel to some – are mainly aimed at making public finances more sustainable in light of an ageing population. They do very little to improve the country's economic competitiveness. To structurally improve Germany's international competitiveness, the government would have to be much bolder. Think of a substantial reduction of bureaucracy, regulation and taxes. Or a long-term strategy for affordable energy, better education and more innovation. And much more.

Against the political background of the three regional state elections of recent weeks, however, the federal government once again looks fragile. In a political landscape increasingly characterised by a strengthening of the extreme edges and a pulverised centre, agreeing on a longer-term strategy and actually pushing it through has become a virtually indispensable challenge.

All in all, despite the long list of potential downside risks, the German economy is enjoying unexpected resilience and even a small cyclical rebound. However, at the risk of being your

favourite party spoiler, a cyclical rebound does not automatically make for a structural recovery and does not offset the urgent need for structural change. But it's a start.

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