

»» The sawtooth shape of Germany's business cycle is gradually levelling out

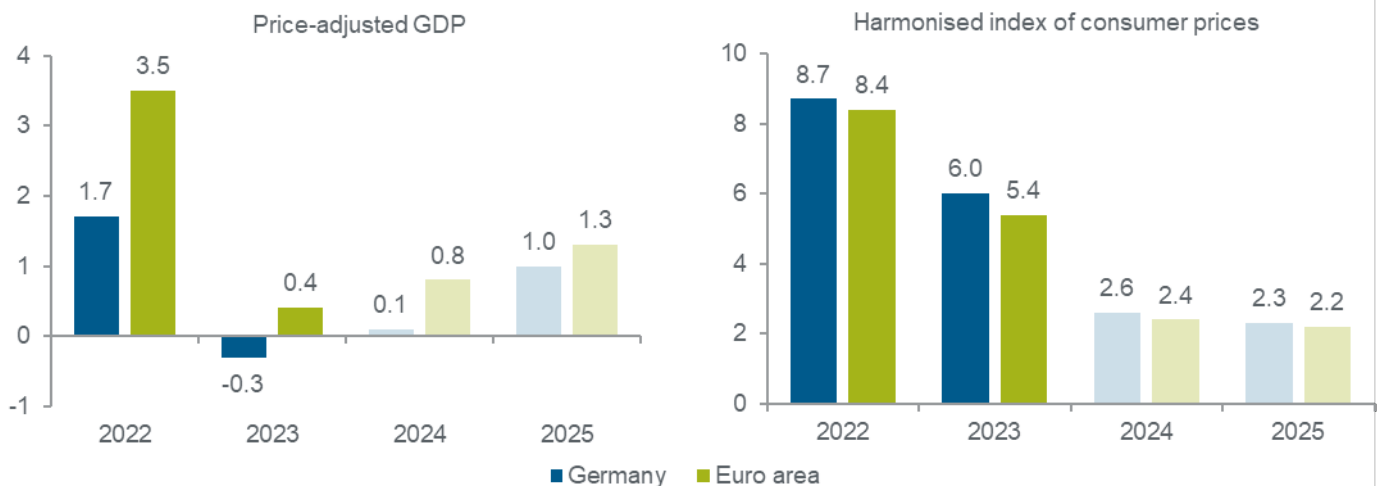
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- After growing at the start of 2024, Germany's GDP contracted in the second quarter, prolonging the sawtooth-shaped business cycle. For the past two and a half years, every rise has been followed by a drop in the subsequent quarter. The economy looks set to grow moderately in the third quarter of 2024.
- The sharp drop in the inflation rate and strong increases in nominal wages mean that the conditions for a consumption-driven rebound are intact. Besides, it is likely that key interest rates will be reduced further, reviving investment in the coming year.
- However, the recovery will set in later and be slightly weaker than was expected in the spring. KfW Research has revised its economic forecast for Germany to 0.1% in 2024, followed by 1.0% in 2025 (previous forecasts: +0.3% and +1.2%).
- Ecological price tag for GDP: Assuming the economy will perform as predicted, Germany's greenhouse gas emissions are set to decrease further. Germany will presumably remain below the caps established in the Federal Climate Change Act for the period from 2024 to 2025.
- Inflation will take time to ease further, especially because the recent drop in underlying inflation remained slightly below expectations. KfW Research expects Germany's inflation, as measured against the HICP, to sit unchanged at 2.6% in 2024 and fall to 2.3% next year (previous forecast: +2.2%).
- In the second quarter, the euro area stayed on the growth trajectory it initiated at the start of the year, which was in line with expectations. KfW Research has left its GDP forecast for 2024 unchanged at 0.8%. We have revised the forecast for 2025 downward slightly to 1.3% (previous forecast +1.5%). After 2.4% this year, inflation should moderate to 2.2% in 2025 (previous forecasts: 2.4% and 2.0%).

Figure 1: Economic growth and inflation

Per cent year-over-year change



Sources: KfW Research, Destatis, Eurostat

German GDP contracted marginally in spring of 2024

Germany's gross domestic product (GDP) adjusted for price, seasonal and calendar variations shrank by 0.1% in the second quarter of 2024, after growing by 0.2% in the first quarter. The sawtooth-shaped business cycle thus continues. For the past two and a half years, every increase has been followed by a decrease in GDP in the subsequent quarter. On balance, current economic output is little higher than before the outbreak of the pandemic. The listless performance in the spring is mainly due to lower investment in construction, machinery and equipment. The decline in construction investment was to be expected since the exceptionally mild weather in late winter greatly benefited construction activity in the first quarter. At the same time, weak investment in plant and equipment reflects the persistent problems of the German industrial sector. After the now implemented major revision of national accounts, Destatis has also reported another price-adjusted 0.3% contraction of GDP for all of 2023, after revising it upwards slightly to -0.2% in the previous quarter.

Business cycle lacked momentum at the start of summer

The business survey-based soft economic indicators, the increases of which had still nurtured justified hopes for an incipient upturn, are now spiralling downward again. Thus, the Ifo Business Climate Index fell for the fourth consecutive month in August and the Composite PMI for Germany has remained below the growth threshold of 50 points since July after slightly surpassing it from April to June. Even if these indicators recently correlated only loosely with economic growth, they at least suggest that the business cycle will remain without momentum for now. The industrial indicators also show that the lull will continue for the time being. Thus, the 1.5% rise in industrial production in June over the previous month only offset less than half of the slump in the preceding month of May (-3.4%) so that in the second quarter it remained 1.1% below the previous quarter in total. At the same time, businesses are continuing to clear the backlog of orders that had accumulated during the global supply chain problems as they are not yet receiving enough new orders. To be sure, after five straight monthly declines, the volume of orders received by manufacturers rose in June for the first time this year. But even the quite strong 3.9% increase compared to May was too little to arrest the downward trend. It fell nearly 12% short of the previous year's level of June 2023 and, despite the rise in June of this year, the second quarter was also still 1.4% lower than the first quarter. Only the volume of orders without the inclusion of the volatile large orders is giving some hope that demand for industrial goods may at least have bottomed out now. It rose by 1.4% in the second quarter. This fits in with the fact that the truck toll index, which closely correlates with output in the producing sector, roughly stagnated in June and July.

Conditions for consumption-driven recovery are intact

The economic news around consumption, on the other hand, is encouraging. Consumer confidence has improved substantially since the low of January. With the exception of a minimal dip in June, it has increased noticeably every month since, including in July. As the inflation rate is now much lower than in recent years and nominal wages have increased sharply, the conditions for a spending-driven recovery remain intact, especially since the number of people in employment continues to rise moderately despite the economic downturn because of the

skilled labour shortage. The numerous uncertainties around the economic outlook for Germany, however, have also sent household savings rates soaring, so that the quite strong real wage increases will translate into only moderately and gradually higher spending. Public sector consumption expenditure is likely to pick up again in 2024 and 2025 as well, after falling in 2023 for the first time since 2004 as a result of the end of state-funded pandemic measures.

Investment unlikely to grow until 2025

Gross fixed capital formation, however, is unlikely to rebound before next year. After the ECB lowered interest rates for the first time in June, any further loosening of monetary policy is likely to proceed only at a slow pace in light of persistently high services inflation and the monetary tightening from previous years is having a lingering effect. Still, this summer there are signs of a positive trend reversal in credit demand from businesses and the construction and acquisition of dwellings. Nonetheless, a further noticeable decline must be expected in 2024 in the particularly interest rate-sensitive segment of residential construction investment despite the strong, weather-driven surge at the start of the year. Business investment could stabilise in the second half of the year, as suggested by the growth in credit demand. But it will nevertheless be much lower in 2024 than in 2023 because of the preceding weakness. Public sector investment, on the other hand, will probably grow, mainly thanks to higher defence spending under the special fund for the German Armed Forces. The dampening effect of global monetary policy will then ease noticeably in 2025, primarily benefiting the construction and manufacturing sectors as producers of capital goods. Private sector investment in dwellings should then expand again for the first time in five years, bolstered by continuing strong housing demand. Export and import demand will gradually rebound after the declines of the past year, although foreign trade is unlikely to provide any significant impetus for economic growth in 2024 or 2025.

GDP will grow by 0.1% in 2024 and 1.0% in 2025

All in all, our summer forecast sees the German economy returning to slow growth in the third quarter which will then slightly pick up pace in the subsequent quarters. As the recovery continues to be delayed, however, and given the statistical underhang – that is, the low starting level for this year's annual growth as a result of the sharp contraction at the end of the previous year – we now expect only a minimal growth rate of 0.1% for all of 2024 (previous forecast: +0.3%). For the coming year we now expect growth of 1.0%, although the downward revision from the previous forecast (+1.2%) is purely technical.¹ With quarterly rates for 2025 remaining unchanged on our previous forecast from May, the lower statistical underhang is now having a negative impact as a result of weaker growth this year. A GDP growth rate of one per cent is noticeably higher than current estimations of the growth of German production potential, which the Federal Government, for example, put at only 0.6% in its spring forecast for the coming year.² Irrespective of the expected economic recovery it is therefore necessary to durably strengthen the long-term growth potential by improving supply-side conditions. The Federal Government's new growth initiative³ is an important step in the right direction as it aims to improve the framework and provide incentives for more investment, reduce bureaucracy and increase the availability of skilled labour.

Annual GHG caps are being met

Even if it is foreseeable that the German economy will return to a moderate path of growth, significant structural challenges remain. In the medium to long term, transitioning the economy and society to carbon neutrality will likely be the greatest of these challenges. According to the Ecological Price Tag for GDP, the indicator which we published for the first time in the autumn of 2022, our current economic forecast implies that greenhouse gas (GHG) emissions will continue to fall. The annual caps on GHG emissions that were newly introduced for the current decade under the amendment to the Federal Climate Change Act will presumably be met in 2024 and 2025 (see annex). Nonetheless, the urgency to act on climate change remains high in order to also meet the GHG reduction target of 65% by 2030 and the long-term goal of climate neutrality by 2045, particularly in buildings and transport.

Inflation: Homestretch is becoming longer

As expected, inflation has been experiencing a sideways movement since the spring in both Germany and the euro area. In July 2024, the inflation rate as measured by the annual variation of the Harmonised Index of Consumer Prices (HICP) was slightly higher than in April in both economic areas, rising from 2.4 to 2.6%. German consumers had to pay more for services in particular than the year before. To be sure, the renewed acceleration of price increases in this economic segment to 4.4% (April: +3.6%) was driven mainly by the absence of the downward effect on inflation of the 49-euro ticket that was introduced in May of last year. The fact that this effect is so palpable is also due to the absence of a clear easing of monthly price increases from service providers. A sharper rise in the overall inflation rate was avoided thanks to the further slowing of annual price increases for industrial goods to what is now a very low rate of 1.1%. Furthermore, energy prices for consumers followed an unexpectedly favourable trajectory despite the Middle East conflict and dropped even more sharply below the previous year's levels since April. These two deflationary factors, however, must be expected to lose strength in the months ahead. Thus, producer prices for consumer goods (without food) have been rising more strongly again year-on-year since March and market prices for natural gas and electricity are clearly trending upwards. At the same time, a further reduction in the price of oil seems unlikely given the very tense conflict situation. The overall inflation rate must therefore be expected to remain around the current level until the end of the year even if the upward trend in prices for services weakens as expected. While we confirm our inflation forecasts of +2.6% for Germany and +2.4% for the euro area for 2024, we have raised them slightly for the coming year because of the now higher baseline levels of underlying inflation. The increase in consumer prices is likely to sit at 2.2% in the euro area (previous forecast: +2.0%) and 2.3% in Germany (previous forecast: +2.2%) in 2025.

Euro area is growing as expected

In the spring, the euro area continued the recovery which started in the first quarter. With price, seasonally and calendar-adjusted growth of 0.3%, second-quarter GDP grew at roughly the rate predicted in our spring forecast. Spain's economy expanded again strongly at a rate of 0.8%. France and Italy recorded growth rates of 0.3 and 0.2%, respectively, while Germany disappointed. Since the beginning of the third quarter, however, the economic indicators for the euro area

have largely softened. The composite output Purchasing Managers' Index (PMI) in particular, which was quite reliable up until the pandemic, slipped in July to a level that now indicates merely a stagnation. It recovered in August but mainly because a very sharp rise in the services component lifted the index for France to a 17-month high, a one-time effect that is likely due primarily to the Paris Olympic Games and will accordingly reverse again already in September. Consumer confidence, however, has continued to recover. On balance, we therefore expect growth to slow only temporarily in the third quarter before the euro economy is likely to return to a similar pace of growth as in the first half of 2024. Our forecast remains unchanged at 0.8% real growth for all of 2024, followed by 1.3% in 2025 (previous forecast +1.5%). Consumption is likely to remain the main driver of growth in the euro area too, as it is in Germany, before the upswing broadens in the coming year. Spain will presumably remain the growth champion among the large euro countries (see Table 1).

Table 1: Price-adjusted GDP growth in the euro area

Per cent year-over-year change

	DE	FR	IT	ES	EA
2022	1.7	2.6	4.0	5.8	3.5
2023	-0.3	0.9	0.9	2.5	0.4
2024	0.1	1.2	0.8	2.7	0.8
2025	1.0	1.1	1.0	2.0	1.3

Source: Destatis, Eurostat, KfW Research

Germany is likely to expand again at a comparable rate as France and Italy next year. The impetus from the current boom in tourism in Spain is likely to weaken slightly in the coming year but the use of the still very high EU funds from NextGenerationEU (NGEU) will continue to drive growth. NGEU should provide significant growth impetus in Italy during the forecast period as well. At the same time, however, there is still a significant need for consolidation in the Italian national budget as a result of the very high fiscal deficit which has prompted the European Commission to initiate an excessive deficit procedure. To what extent this will create an economic burden is one of the great uncertainties of the economic forecast. This applies not just to Italy but even more to France, for which an EDP was also initiated. France has also been plunged into major political uncertainty after the early elections held at the beginning of July, while support from the NGEU programme is negligible. For our forecast, we expect the budget consolidation in the euro area to be undertaken so gradually under the new EU fiscal rules that it will place only a moderate burden on economic growth.

Economic risks

Among the persistent forecast uncertainties are the geopolitical and geoeconomic risks, particularly in connection with the Middle East conflict and Russia's invasion of Ukraine. Should there be a significant escalation in the Middle East conflict, a blockade of the Strait of Hormuz could lead to a new oil price shock with considerable increases in inflation and growth losses. The process of geoeconomic fragmentation poses a structural challenge for Germany and the euro area but it could have an unexpectedly negative impact already during the

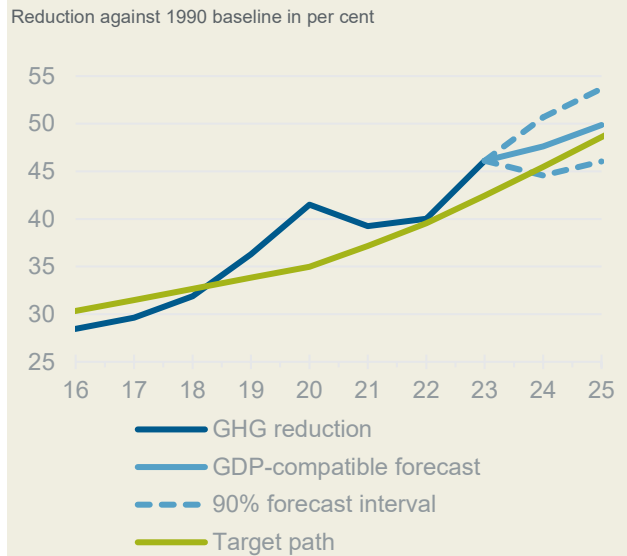
forecast period, for example if the trade conflict between the US and China escalates or the dispute over subsidies between the EU and China comes to a head. Even if the shift from Joe Biden to Kamala Harris as the Democratic candidate for the presidency means that the outcome of the US presidential election on 5 November is now a toss-up again, the continuing possibility of a re-election of Donald Trump as US president is a direct risk to German industry through the trade channel. It could also cause the US economy to overheat, which in turn would probably worsen global financing conditions. With Trump as US president, the issue of military security in Europe would also have to be reassessed, with potentially significant consequences for public spending. The high public deficits and debt levels in some EU countries also pose the risk of new sovereign debt crises, particularly since there is likely to be little support for consolidation measures in the new French parliament. However, the economy may also develop more positively than predicted if households reduce at least part of their recently increased precautionary savings in favour of higher consumption. A Harris victory would likely reduce concerns over new foreign trade barriers, which in turn could encourage the export-oriented German industry to invest more.

Annex: Ecological price tag for GDP

Economic growth has a wide range of social and ecological consequences that are typically disregarded in the usual economic forecasts. It is a necessary but not sufficient condition for sustained prosperity, as the growing risks from climate change demonstrate in dramatic fashion. Global heating poses a threat to the natural bases of human life and, thus, to economic activity. It is therefore high time to focus more comprehensively and rigorously than before on the impact of economic activity on the environment and climate in particular.

To this end we have developed a simple approach for systematically integrating the expected greenhouse gas (GHG) emissions into our economic forecast for Germany. The starting point is an identity equation according to which total GHG emissions are the product of GDP and the emission of GHG per unit of GDP, in other words, GHG intensity. We take the GDP from our economic forecast and estimate the expected development of GHG intensity using a linear trend extrapolation. Our approach is explained in detail [here](#). It enables the greenhouse gas emissions being expected under current conditions to be compared with the reduction targets set by policymakers, which require Germany to reduce its emissions by 65% against the 1990 baseline by A1 (see Figure A1). In the amendment to the Federal Climate Change Act⁴ the reduction target for 2030 remains unchanged but will now be supplemented by concrete GHG emission caps for each year from 2020 to 2030. The target trajectory in Figure A1 is based on these caps.

Figure A1: GHG emissions in Germany



Source: Destatis, Eurostat, KfW Research

The systematic comparison of expected economic growth and GHG emissions will sharpen our awareness of the trade-off that exists between more goods and income on the one hand and the consumption of key natural resources on the other hand. It means we attach an ecological price tag to GDP, as it were, that will tell us how much the expected growth will presumably cost us as a society in the form of GHG emissions that harm the climate.

On the basis of our new economic forecast, the ecological price tag predicts that emissions will drop in the forecast period and in both years will remain slightly below the annual ceilings prescribed by the amended Federal Climate Change Act. Under our approach, GHG emissions in Germany are thus likely to amount to 655 million t CO₂ equivalents in the current year 2024. That would be 27 million t CO₂ equivalents or just under 4% less than the 682 million t CO₂ equivalents set by the act as upper limit for 2024. In the year 2025, GHG emissions should then be 623 million t CO₂ equivalents or roughly 2.5% lower than prescribed by the reduction trajectory (see Table A1).

Table A1: GHG emissions and policy trajectory

Million tonnes of CO₂ equivalents

	2022	2023	2024	2025
Actual/forecast	750	674	655	627
Target path	756	720	682	643
Actual/forecast deviation from target path				
Absolute	-6	-46	-27	-16
Percent	-0.8	-6.4	-3.9	-2.5

Source: Destatis, Eurostat, KfW Research

Like all forecasts, the ecological price tag for GDP also involves forecast risks. With reference to the 90% forecast interval presented in Figure A1, which is derived from the historic forecast errors of our approach, the statement that the annual minimum GHG reduction targets will be reached in the forecast period appears to be empirically validated.

¹ Here we present the original price-adjusted GDP rates, as is customary in Germany. The calendar effect – the influence of year-to-year fluctuations in the number of working days on average annual GDP growth – is low over the forecast period. It is entirely negligible in the current year and accounts for -0.1 percentage point next year. The expected GDP growth rate is therefore 0.1% (2024) and 1.1% (2025) on a price- and calendar-adjusted basis.

² Gesamtwirtschaftliches Produktionspotenzial und Konjunkturkomponenten – Datengrundlagen und Schätzungen der Bundesregierung - Frühjahrsprojektion 2024 (bmwk.de) (*Aggregate economic production potential and cyclical components – databases and estimates by the Federal Government – spring forecast 2024 – our title translation, in German*).

³ Initiative for Growth – new economic momentum for Germany (in German).

⁴ [Federal Government adopts amended Climate Change Act | Federal Government; Document 20/8290 Federal Government's draft law Draft of a second act to amend the Federal Climate Change Act \(bundestag.de\)](#).